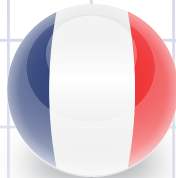
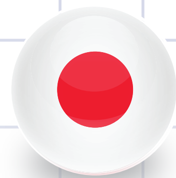
COUNTRY RATINGS REPORT

INCRA

AN INTERNATIONAL NON-PROFIT CREDIT RATING AGENCY





BertelsmannStiftung

BertelsmannFoundation

FOREWORD

In April the Bertelsmann Foundation successfully launched its “Blueprint for INCRA”, which lays out the foundation for the first international, non-profit credit rating agency (INCRA) for sovereign risk. We received an overwhelmingly positive response from governments, international institutions, corporate players, the media and concerned citizens.

INCRA’s governance structure aims to minimize even the perception of conflicts of interest. Its new, comprehensive set of indicators to analyze sovereign risk have been received as a logical and long-overdue approach to reforming and further developing the current system of sovereign risk assessment. The response and feedback we received affirmed our five basic assumptions:

1) We must increase competition within the current credit rating agency (CRA) world by adding another player, based on a non-profit approach and a sound governance model, that would improve accountability and legitimacy.

2) Improving the current system and the way sovereign ratings are conducted is not only of concern to Europeans and Americans, it is a worldwide debate. INCRA pays tribute to this global scope.

3) Sovereign bonds constitute the largest asset class, with nearly US$70 trillion of securities outstanding worldwide. At the same time it is an asset class under unprecedented pressure.

4) Sovereign ratings should be considered “public goods” because their use by any individual does not reduce another’s ability to use them.

5) To increase the quality of the ratings we have defined a more comprehensive and concrete set of indicators that not only focus on the macroeconomic situation of a country but also highlight its socioeconomic development. We have called these criteria forward-looking indicators (FLI).

With this second report we want to demonstrate that the set of indicators we presented in our “Blueprint for INCRA” can be applied to assess the sovereign risk of any country. Therefore, we have simulated “sovereign risk credit rating committee meetings” similar to those that would take place within INCRA and produced sovereign risk reports. Five countries—Brazil, France, Germany, Italy and Japan—were chosen to put our set of indicators to a real rating test.

In this exercise we relied on a team of international macroeconomic, political and sociological experts that, in part, also spearheaded the first INCRA report and have been part of our Bertelsmann Transformation Index (BTI) and Sustainable Governance Indicators (SGI) groups of experts for years. Now we have put our indicators to a real test run that serves two major objectives:

1) To prove that we need both macroeconomic indicators and FLI to come to a solid and serious sovereign risk assessment.

2) To demonstrate that it is possible to present sovereign ratings in a transparent and easily understandable form that pays tribute to the fact that they are public goods.

Overall, we aim to change the perception of sovereign ratings. Instead of seeing them as a national insult in the case of downgrades or, by some commentators, as unpredictable, not serious and not transparent assessments of a country’s fiscal situation, sovereign ratings should be seen as a solid blueprint for analyzing the challenges facing individual governments. We hope that with this report we can make a contribution in this direction.

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INTRODUCTION

With our recent publication of "Blueprint for INCRA: an international, non-profit credit rating agency" (INCRA) we presented a new model for conducting sovereign risk assessment. We placed a special emphasis on a governance structure that would allow the institution to be based on a non-profit model. We also devised a new institutional setup that reflects the international and societal importance of such a credit rating agency (CRA). We also developed a new set of indicators for assessing sovereign risk, which we put to a test run over the last few months, and have subsequently produced country rating reports for five countries. INCRA's strength lies in both its sound governance model and, as we will show in this report, its comprehensive set of indicators and rating methodology.

Why INCRA Makes a Difference

From our point of view, the issue of assessing sovereign risk needs to be addressed from two angles:

- the legal and organizational setup of CRAs: Do we need alternate institutions in addition to the traditional for-profit CRAs, and who is responsible for conducting the research?

- the quality of the provided analysis: Is the current set of indicators used by CRAs to evaluate a country's willingness and ability to pay back its debt sufficient? Do we need more comprehensive indicators that will also increase the predictability of a country's financial performance?

Our proposed agency, INCRA, consists of a non-profit, international network of offices and would use a new legal framework that is based on an endowment solution to guarantee sustainability and security for its long-term existence. Financially supported by a broad coalition of funders, from governments to corporate players to non-governmental organizations (NGOs) to foundations and private donors, it would be an independent entity. INCRA would be based on a robust governance model that would minimize and buffer potential conflicts of interest. Specifically, a Stakeholder Council would separate the funders from the operational business. It would have offices in Europe, the US, Latin America and Asia.

To evaluate a country's "ability and willingness to repay its debts", a more comprehensive set of indicators is needed. That's why INCRA would conduct its sovereign risk assessments through a set of macroeconomic and forward-looking indicators (FLI) that would provide the basis for high-quality analysis. These FLI would capture a meaningful picture of a country's long-term socioeconomic and political prospects and the potential political and/or social constraints on its ability and willingness to pay.

INCRA would pay tribute to the fact that the financial world needs greater buy-in and participation from many different actors of society, such as governments and NGOs. It would also reflect the realities of the globalized financial world, where the quality of sovereign ratings is not only crucial for Europe and the US but also for the emerging economies, such as China and Brazil.

The Value Added of the Sample Ratings

With the sample ratings of this second INCRA report we want to demonstrate that we can:

- produce sovereign ratings that are based on a comprehensive set of macroeconomic indicators, which are quantitative by nature, as well as FLI, which mirror the socioeconomic developments within a country and are qualitative.

- significantly increase the transparency and understandability of a sovereign rating. With this report we present for the first time a "rating radar" that presents a snapshot overview of a country's major strengths and weaknesses. We also provide all the background material that has been used to come to our sovereign ratings. Additionally, we provide a clear overview of the methodology and process that we followed in producing the five sample ratings of this report.

But we can't stress enough the point that ratings are "opinions", which can and should be challenged. Ratings may be subjective, but that does not mean that they do not add value. In spite of all the criticism that sovereign ratings in particular have received in the past, ratings continue to serve a major purpose: they aggregate information regarding the credit quality of borrowers, in our case sovereign entities. They deliver a subjective evaluation and assessment of the ability of countries to meet their debt obligations. The one and only question a sovereign rating seeks to answer is: "What is the country's ability and willingness to repay its debt?" The information sovereign ratings provide is relevant and important for many financial actors, from central banks to major insurance companies to individual investors.

The Underlying Methodology and the Process

In the first INCRA report we presented a detailed overview of the comprehensive set of criteria that informs our sovereign risk assessments. A definition and application of these two sets of quantitative and qualitative indicators have been further developed in two codebooks. These codebooks were published in the first INCRA report but have since been developed and are included in this second report. The codebook served as a basis for each "country committee" that we assembled for each state that we selected. In each committee we had a balanced number of macroeconomists as well as political and sociological scientists who complemented each other. Every country committee followed the same procedure, applying the indicators of the codebooks and discussing differing opinions as well as the indicators that are most important for each country in the medium and long term. The steps of the country committees were:

1) A country expert produced a country report based on the FLI codebook.

2) In parallel, the macroeconomic data for the country was assembled from sources, such as the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), and checked.

3) Each country committee call started with an extensive discussion of the macroeconomic indicators and a presentation of the expert's report based on the FLI, followed by a discussion with all members of the committee. After all aspects of the country had been reviewed and all arguments had been weighed, each member of the committee was asked to give his or her scores for the macroeconomic and FLI performance. The scores ranged on a scale from 1 (very bad performance) to 10 (extremely good performance). If a score on one indicator had a spread that was higher than four points, a discussion began on the discrepancies within the committee. In case it was not possible to bridge the different expert opinions, it is made clear in the rating report that there was a major difference in expert opinions. Each committee had a minimum of five and a maximum of eight voting members. Each member had an equal vote.

4) The opinions of the experts are reflected in each rating report, which was produced by a team of two sovereign-risk experts. The drafts of each rating report were reviewed by each country expert and finalized by sovereign-risk experts.

5) Afterwards the scores were added and weighted according to our INCRA "weight scheme" for high-income, middle-income and low-income countries, meaning that the scheme relies on the per capita income of the country. INCRA proposes for "high-income countries" to weight macroeconomic indicators 40 percent while FLI are weighted 60 percent. If a country is generally stable, it is more useful for investors to look at FLI, since the outlook is not likely to change in the near future. For countries that are more susceptible to economic or political volatility, it is more important to take the macroeconomic indicators into account. For middle-income countries, such as Brazil, the committee weighted 50 percent for macroeconomic indicators and 50 percent for FLI in the final scores because the macroeconomic situation must be monitored more closely.

6) Finally, the overall scores were aggregated and the averages were calculated to produce a rating.

The presented sample ratings are global, meaning they are not regional rankings where a country is compared with the performance of its peers in the region. This global approach allowed us to produce consistent ratings with which we can compare the probability of timely repayment of principal and interest across countries.

The Selection of the Sample Countries

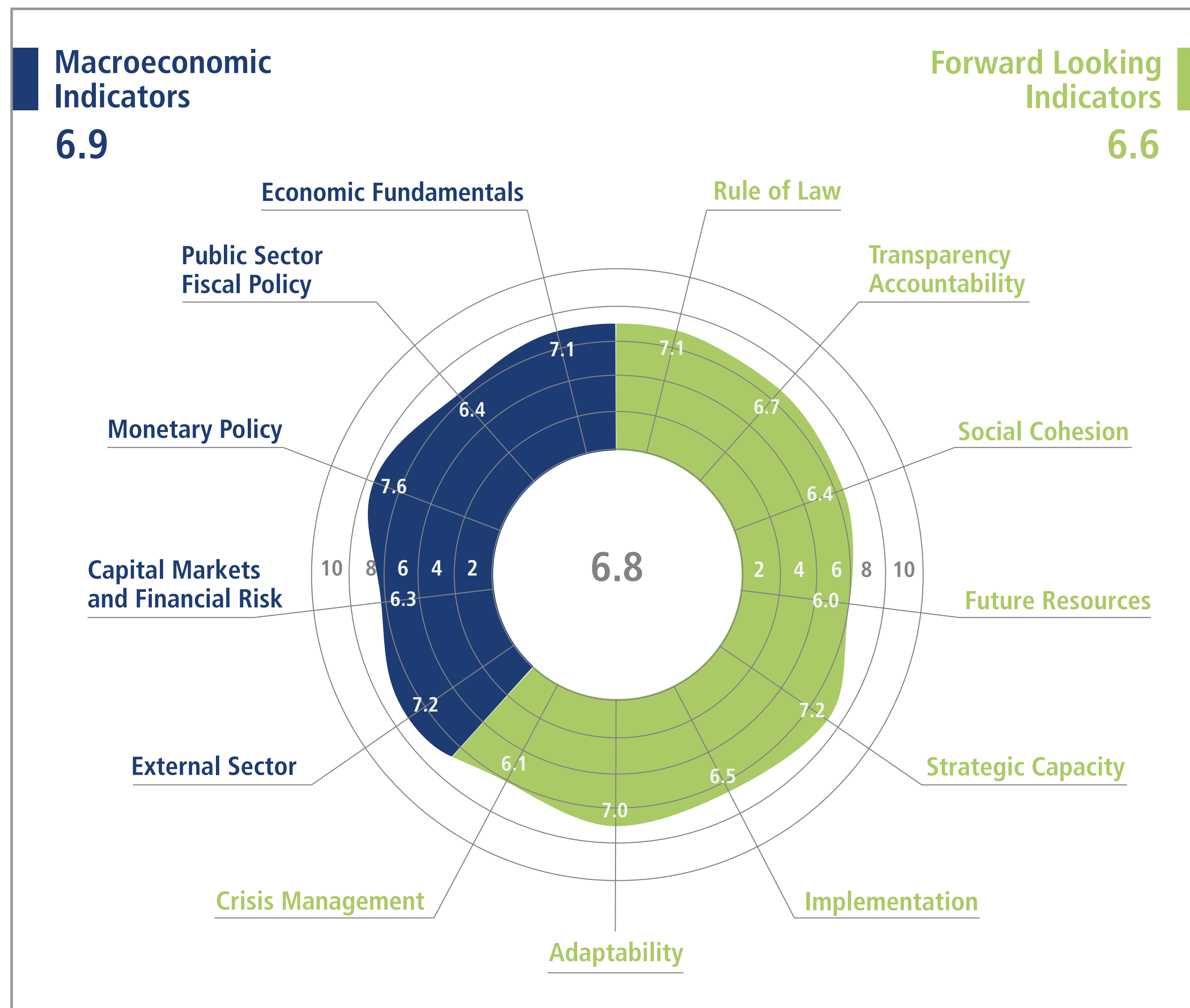
For this report, the Bertelsmann Foundation, in cooperation with its external experts, selected five countries for the sample rating process: Brazil, France, Germany, Italy and Japan.

In choosing Brazil, we wanted to include a vibrant emerging economy that has accomplished a successful transformation process, but still has to overcome many economic and societal challenges to be on a sustainable growth track. We wanted to examine a country like Japan that has been struggling with an economic-, fiscal- and political-transformation process since a crisis in the 1990s. To make a convincing case for the impact of FLI on countries that have a stable macroeconomic situation, but still have potential for reform and greater resilience, we have chosen to evaluate France and Germany. Italy served as an interesting case of a country that has been severely hit by the euro crisis and must still undergo reform.

Our sample ratings illustrate the necessity for more comprehensive and transparent sovereign-risk assessments. Our countries selection is as subjective as sovereign ratings are, and we hope to have provided a diverse and interesting selection of countries for our test run.

BRAZIL

RATING: 6.8 (A+)



Pros:

- Low debt/exports ratio
- Foreign currency debt is a small portion of general government debt
- High level of foreign exchange reserves
- Ongoing primary surpluses
- Flexible exchange rate policy
- Diverse export base
- Strong rule of law for an emerging market country
- Adaptable economic framework

Cons:

- Slowing real gross domestic product growth
- Growing current account deficits
- Rapidly growing domestic credit/GDP ratio
- High M2/foreign exchange reserves ratio
- Deteriorating liquidity ratio
- Per capita income about one-third of advanced industrial countries
- Significant development needs
- History of defaults

Summary

Brazil has made enormous economic progress in the last 15 years. At the same time, the country still faces significant and demanding challenges. Since 1995, political, legal and socioeconomic institutions have become increasingly effective in implementing a successful development strategy. Given the country's volatile political and economic history, the past three administrations have emphasized a strong constitutional framework, alongside what Brazil calls a socially responsible market economy. This combination has provided economic stability and enhanced the government's legitimacy.

Most macroeconomic indicators have improved sharply. In addition, the country scores relatively well compared to emerging market peers on FLI.

The Brazilian government still faces the enormous challenge of trying to bring a larger proportion of its population into the formal sector. This is complicated by significant regional economic differences between the more developed South and the less developed North. Also, the government must deal with sharply skewed income and wealth distribution nationwide.

All in all, Brazil's progress over the last 15 years warrants an investment-grade government bond rating. The country's large foreign exchange reserves, the much lower dependence of the government on foreign-currency debt issuance and an increasingly vibrant corporate sector are together consistent with Brazil's A+ rating.

The Economy

Despite the worldwide financial crisis, Brazil's GDP increased by over US$1 trillion between 2007 and 2011. Growth in Brazil's per capita income has also been remarkable, rising from US$8,629 in 2008 to US$12,628 in 2011. Measured on a purchasing-power-parity basis, removing price distortions and exchange-rate fluctuations, the improvement is not as large, but is still significant, rising from US$10,405 in 2008 to an expected US$12,495 in 2012.

As illustrated above, Brazil appears to have successfully navigated the global financial crisis. While the country's GDP contracted by 0.3 percent in 2009, economic growth rebounded strongly in 2010 when GDP grew by 7.5 percent, the highest growth rate in more than 20 years. The activities of regulatory agencies in key sectors and a greater reliance on competition helped Brazil's economic performance, notably in the private health-insurance sector. However, concerns have been raised recently about the government's use of government-sponsored enterprises (GSEs) to foster economic reform. The government is running up against growing opposition within the private sector to policies that allegedly use the pricing power of large GSEs, particularly in the financial and the energy sectors, to force more competition within the private sector.

GDP Growth

In 2011, GDP growth slowed to 2.7 percent. This year, according to the International Monetary Fund (IMF), GDP growth is expected to remain anemic. The slowdown is blamed on two factors: infrastructure constraints and weaker demand for Brazil's commodities. Weaker Chinese demand for Brazilian commodities is a result of China's own economic slowdown. China plays an important role in Brazil's economic success, not only as an important importer of Brazilian products, but also for maintaining worldwide demand, which has boosted commodity prices.

The Brazilian government recognizes the constraints on the economy caused by the inadequate infrastructure. The government inaugurated a multi-billion dollar Growth Acceleration Program (GAP), which over the next several years aims to improve the country's roads, ports, railways, airports and communications facilities. Nonetheless, many observers argue that even after all GAP projects are complete, the country will still fall short of the infrastructure required for the economy to grow rapidly over time.

Labor Market Conditions

Brazil poses an interesting problem when looking at unemployment. In August 2012, the unemployment rate was an enviable 5.3 percent. The unemployment rate peaked at 13.1 percent in August 2003. Since 2001, unemployment has averaged about 9 percent. However, this number is not really comparable to what we would find in advanced industrial countries since the bulk of the work force remains in the informal sector. Brazil's real employment challenge is to bring more of the population into the formal sector, which will take decades.

Inflation

Historically, Brazil has suffered from excessive inflation. In fact, in the 1990s the government was forced to freeze the domestic payments system to prevent the economy from spiraling into hyperinflation. For decades, inflation was one of the country's thorniest issues. It wasn't until 2003 that the country began what has turned out to be a sustained period of single-digit inflation. It can be argued that Brazil may have finally have broken its tendency towards excessive inflation.

As measured by the consumer price index (CPI), inflation increased to 6.5 percent in 2011, compared to an average of 5.3 percent in the 2008-2010 period, or well above the central bank's mid-point target of 4.5 percent. In September 2012, the inflation rate reached a seven-month high of 5.3 percent. This increase in inflation highlights

the underlying policy mix in Brazil: a relatively loose monetary policy alongside a relatively tight fiscal policy. Despite inflation remaining above the central bank's target rate for over two years, slower growth is now apparently viewed as the greater risk. Evidence for that is found in the central bank's interest-rate policy. Despite inflation above the target rate, the central bank has nonetheless lowered its key benchmark interest rate by 5.25 percentage points between August 2011 and August 2012. If inflation were the key concern, the central bank would not have lowered rates so aggressively.

Rapid Financial Deepening

An important result of the lower inflationary environment and lower interest rates in general has been the sharp rise in consumer and corporate credit. Although Brazil lacks the deep financial system of more-developed countries, it has witnessed a significant deepening of the financial system. For instance, the domestic credit/GDP ratio went from 31.1 percent in 2004 to 95.5 percent by year-end 2011. This represents an important movement forward for Brazil. At the same time, however, the speed of the increase in domestic credit is potentially worrisome. In most countries, such a sharp rise in credit consumption has usually been associated with rising credit risk. Even in advanced industrial countries, significant increases in credit can easily outpace the ability of financial institutions to analyze the additional credits taken on their balance sheets.

Brazil generally has relatively strong financial supervision. However, as the financial system has become ever more sophisticated, and as the monetization of the economy continues to grow, the ability to carry out adequate supervision will be severely taxed. In particular, recent rapid credit growth, noted above, has created potential banking-sector vulnerability. Still, the non-performing loans to total loans ratio is low at just 3.8 percent overall, and in government-owned banks it is 2 percent. Capital and liquidity ratios are high.

Balance-of-Payments Constraints

The Brazilian economy has traditionally been viewed as balance-of-payments constrained. In other words, whenever the economy grew rapidly, investment needs rose and quickly outstripped domestic savings. This caused large current account deficits. As the deficits grew, and foreign-currency debt was accumulated, financing future current account deficits became more burdensome. On numerous occasions, Brazil faced balance-of-payments crises. Brazil's crises were often so serious that the government was forced to reschedule the country's foreign-currency debt. It would not be inappropriate to label Brazil a serial defaulter.

As is true in many areas of the Brazilian economy, a significant change occurred after the election of President da Silva, most often referred to by his nickname, Lula. Between 2003 and 2007, the country annually ran current account surpluses. However, in 2008, Brazil again started recording current account deficits. What distinguishes the period from 2008 to the present from Brazil's earlier record of current account deficits is that the recent string of deficits, when measured as a percent of GDP, has been relatively low. Foreign direct investment, a non-debt creating capital inflow, has been able to fund the current account deficit. As a result, over time, despite annual current account deficits, the external debt/GDP ratio went down sharply, falling from 54.4 percent of GDP in 2002 to 14.9 percent in 2009. Since 2009, that ratio has increased, but only marginally, to 18.1 percent by 2011. Not surprisingly, the debt/exports ratio also fell from a risky 300 percent in 2002 to a much less risky 130 percent in 2011. Another important external ratio that improved was the debt service ratio. It went from an exceedingly high 65.8 percent in 2002 to a much more comfortable 17 percent in 2011.

Foreign Exchange Reserves

Foreign exchange reserves have soared in the last 10 years. In 2002, foreign exchange reserves were a paltry US$37 billion. In August 2012, reserves totaled US$377 billion, or the eighth-largest reserves in the world. All in all, developments in the overall balance of payments point to a lower level of foreign currency credit risk than was true in the past.

Fiscal Policy

Over the last decade, Brazil's governments have successfully restored fiscal discipline through the use of fiscal rules, enhanced expenditure controls, and a high degree of fiscal transparency. The country possesses a well-established legal framework for the formulation, execution and monitoring of the budget, including a strong focus on the medium term. This helps ensure that fiscal policy measures are considered affordable and sustainable. As such, the government is now better able to adjust more smoothly to potential fiscal shocks. About two-thirds of primary spending is dedicated to social sectors, including social security. Two of the most prominent programs have been Bolsa Familia and Fome Zero, one aimed at improving living standards of the poor and the other aimed at ending hunger in Brazil. Both programs have received international praise.

Primary Surpluses

Containing social security spending, particularly pensions (at over 7 percent of GDP in 2008), remains a major challenge. A disciplined fiscal policy has led to ongoing general government primary surpluses, which averaged 3.7 percent of GDP between 2007-2011. Primary surpluses in excess of 3 percent are expected to continue over the medium term. Financial deficits over the same period averaged 2.6 percent of GDP, reflecting a still substantial outstanding debt and relatively high interest rates on that debt. Debt to revenue was 180 percent in 2011.

Differences in Emerging Market Economies

When discussing fiscal policy, it is important to make a distinction between advanced industrial countries and emerging market economies. Advanced industrial countries are able to carry much more public sector debt than emerging market countries. The reason is that wealthy countries usually have deep financial markets at home or easy access to such markets in other countries. Another important distinction is that high-income countries usually have more diversified income streams as well as more accumulated assets, either at home or abroad. This is one reason that we compare countries to their income peers. This is why Brazil's debt/GDP ratio and debt/revenue ratio are considered acceptable within its income peer group, despite being well below similar ratios in advanced industrial countries like Germany or France. For instance, in 2002 when the Brazilian government teetered on the brink of default on its local-currency-denominated debt, the debt/GDP ratio was only 62.7 percent with a debt/revenue ratio of only 181 percent. The problem at the time was concern that then-newly elected President da Silva might pose an economic/financial risk, which was difficult for markets to estimate. Obviously, President da Silva subsequently proved market concerns to be mistaken.

Forward-Looking Indicators (FLI)

Brazil scores best in three areas: 1) rule of law; 2) adaptability; and 3) strategic capacity. It performs lower in three categories: 1) future resources; 2) crisis management; and 3) social cohesion. Not surprisingly, overall Brazil scores below Germany, France and Italy, but interestingly it scores higher than Japan.

For an emerging market country, Brazil's respect for rule of law is relatively strong. It has a powerful judiciary, which has on numerous occasions limited government action when that action was viewed as unconstitutional. Also, private contracts and private property rights are generally respected despite land tenure problems in the country's poorer north.

Given Brazil's long history of a relatively volatile economic environment, Brazilian governments have proved adaptable. In the past, sometimes the changes were not undertaken on a timely basis. However, since 2003 the policy framework has improved significantly, for the first time channeling the country's natural adaptability in a more orderly direction.

Brazil also scores relatively well in the category of strategic capacity. As noted earlier, Brazilian governments successfully restored fiscal discipline, enhanced expenditure controls and introduced a high degree of fiscal transparency. There is now a legal framework to formulate, execute and monitor the budget. There is a strong emphasis on the medium-term budget outlook.

Brazil scores less well regarding future resources. One of the government's long-term problems has been its pension system. Although important reforms have been made, the system still poses a fiscal burden. Also, as noted above, a large percentage of the population remains outside the formal sector. Bringing these people into the formal sector will take time and resources. The need for infrastructure improvements will remain substantial.

In the rating committee, crisis management in Brazil proved to be a contentious issue. By any measure, since 2003 the Brazilian government has demonstrated its ability to manage crises. For instance, the government was able to avoid the worst effects of the 2008 global financial meltdown. However, there was a minority view that the time horizon to measure Brazil's crisis management should be longer and more closely related to debt management. That minority view weighed Brazil's debt reschedulings and frequent financial crises of the '80s and '90s as relevant. As such, since the majority view emphasized the post-2003 experience, Brazil's crisis management score was lower than some of its other indicators, but not as low as it would have been if the minority view had prevailed.

Brazil scored weak on social cohesion. Despite the fact that the government has made great strides in recent years to reduce the level and depth of poverty, there still remain strong income and wealth disparities. Also, although racial tensions are lower than in some other countries with a varied racial mix, full racial integration remains only a distant goal.

Recent Political Developments

Brazil's political and policy environment has remained steady over the last decade, with policymakers committed to implementing prudent fiscal and monetary policies effectively. Steadfast commitment to addressing deep-rooted social issues has led to significant transfer programs and improvements in education. As a result, income distribution indicators have dramatically improved and millions of Brazilians have moved out of poverty. The poverty rate has fallen markedly, from 20 percent in 2004 to 7 percent in 2009, while extreme poverty dropped from 10 percent to 4 percent. Between 2001 and 2009, the income growth rate of the poorest 10 percent of the population was 7 percent per year, while that of the richest 10 percent was 1.7 percent.

This has helped decrease income inequality. However, despite many reforms and remarkable social improvements, Brazil's inequality levels remain among the highest in the world. Millions of people still live in poverty, while social exclusion is quantitatively and qualitatively pronounced and structurally ingrained.

The current government of President Dilma Rousseff of the Workers Party (PT) assumed power in January 2011. She leads a coalition government, a common feature in Brazil. Rousseff has proved a popular leader who has continued prudent macroeconomic policies. However, since assuming office, the Brazilian government has had to deal with a rapidly slowing economy. Although the country considered itself lucky to have avoided the worst aspects of the global financial crisis, the country is now faced with its aftermath, including the sovereign debt crisis in Europe, China's slowing economic growth, moderating commodity demand and a slow-growing US economy.

The risk facing the government is that the present worldwide economic malaise not only lasts, but deepens. Given that it is impossible to predict with certainty how the world economy will perform in 2013, what is important regarding Brazil sovereign risk is whether the existing policy framework would effectively cushion government finances from negative impacts of slower world growth. Since Rousseff is Brazil's first economist president, she has the technical knowledge regarding how to maintain the economic gains her country has made in the last 10 to 15 years. In addition, the political elite appears to understand the importance of a relatively tight fiscal policy. The wild-card risk is that the present loose monetary policy may trigger a return to higher inflationary expectations in Brazil. That could unleash problems for the economy down the road. To date, these concerns remain only speculative in nature.

Country Committee Average Scores

MACROECONOMIC INDICATORS	6.9
Economic Fundamentals	**7.1**
Real GDP Growth %	7.0
GDP Per Capita	6.2
Real Exports (% Change)	8.0
Real Imports (% Change)	7.6
Gross Domestic Investment/GDP (%)	6.6
Gross Domestic Savings/ GDP (%)	6.5
Inflation-CPI (%)	7.4
Population Growth (% Change)	7.6
Public Sector / Fiscal Policy	**6.4**
General Government Debt/GDP (%)	6.5
Nominal GDP Growth (Local Currency %)	6.8
General Govt Debt/General Govt Revenue (%)	6.2
General Govt Interest/General Govt Revenue (%)	6.0
General Govt Primary Balance/GDP (%)	7.6
General Govt Fiscal Balance/GDP (%)	6.8
General Govt Revenue/GDP (%)	6.0
General Govt Expenditure/GDP (%)	5.0
Monetary Policy	**7.6**
Accommodative Monetary Policy	7.6
Capital Markets and Financial Risks	**6.3**
Domestic Credit/GDP (%)	6.6
Domestic Credit (% Change)	5.2
Overall Strength of Banking Sector	7.0

External Sector	7.2
Current Account	6.9
External Debt	7.8
M2/Foreign Exchange Reserves	5.8
Reserves to Imports (Months)	7.8
Debt Service Ratio (%)	7.2
Short-Term External Debt/Total External Debt	8.2
External Short-Term Debt / Current Maturities Due on Medium to Long External Debt/FX Reserves	7.8
Total Liabilities Owed to BIS Banks/Total Assets Held in BIS Banks	6.4

FORWARD LOOKING INDICATORS	6.6
Political Economic and Social Stability	**6.5**
Rule of Law	**7.1**
Legal Certainty	6.6
Independent Judiciary	6.7
Separation of Powers	7.4
Property Rights	7.6
Transparency / Accountability	**6.7**
Corruption Prevention	5.8
Independent Media	7.5
Civil Society Participation	6.8
Social Cohesion	**6.4**
Social Inclusion	5.7
Trust in Institutions	6.3
Societal Meditation	6.6
Conflict Management	6.8

Future Resources	6.0
Education	5.4
Research and Innovation	5.4
Employment	7.4
Social Security	5.8
Environmental Sustainability	6.2
Steering Capability and Reform Capacities	**6.7**
Strategic Capacity	**7.2**
Prioritization	7.2
Policy Coordination	7.0
Stakeholder Involvement	7.2
Political Communication	7.2
Implementation	**6.5**
Government Efficiency	6.7
Resource Efficiency	6.3
Adaptability	**7.0**
Policy Learning	7.2
Institutional Learning	6.8
Crisis Management	**6.1**
Historical Evidence of Crisis Management	6.2
Crisis Remediation	5.9
Signaling Process	5.9
Timing and Sequencing	6.2
Precautionary Measures	6.0
Automatic Stabilizers	6.2

BRAZIL MACROECONOMIC INDICATORS

I. Economic Fundamentals	2008	2009	2010	2011	2012f
Nominal GDP Growth (LC %)	13.9	6.8	16.4	9.9	8.1
Real GDP Growth (%)	5.2	-0.3	7.5	2.7	2.5
Real Exports (% Change)*	-2.5	-10.8	9.5	2.9	3.5
Real Imports (% Change)*	17.6	-17.5	38.2	8.9	5.0
Nominal GDP (bn US$)	1653	1622	2143	2493	2438
GDP per capita (US$)	8,629	8,392	10,993	12,628	12,885
GDP per capita (PPP basis: US$)	10,405	10,389	11,202	12,072	12,495
Inflation-CPI (%)	5.9	4.3	5.9	6.5	4.8
Population Growth (% Change)	0.92	0.89	0.88	0.88	0.87
Gross Domestic Investment/GDP (%)	20.7	17.8	20.2	20.6	21.2
Gross Domestic Savings/GDP (%)	19.0	16.3	18.0	18.5	18.6

*Exports/Imports include goods only

II. Public Sector Policy	2008	2009	2010	2011	2012f
General Government (GG) Debt/GDP (%)	63.5	66.9	65.2	64.9	64.2
GG Revenue/GDP (%)	38.6	38.7	41.6	41.7	41.7
GG Expenditure/GDP (%)	41.0	42.0	44.2	44.2	44.4
GG Financial Balance/GDP (%)	-2.4	-3.4	-2.6	-2.5	-2.7
Primary Balance/GDP	3.4	2.0	2.7	3.0	2.4
GG Debt/GG Revenue (%)	179.4	196.2	182.1	182.8	180.8
GG Interest/GG Revenue (%)	15.1	14.0	12.7	13.2	12.2

III. Capital Markets & Financial Risk	2008	2009	2010	2011	2012f
Domestic Credit (% Change)	5.1	-1.1	-0.7	5.8	1.1
Domestic Credit/GDP (%)	96.9	95.8	95.2	95.5	96.0

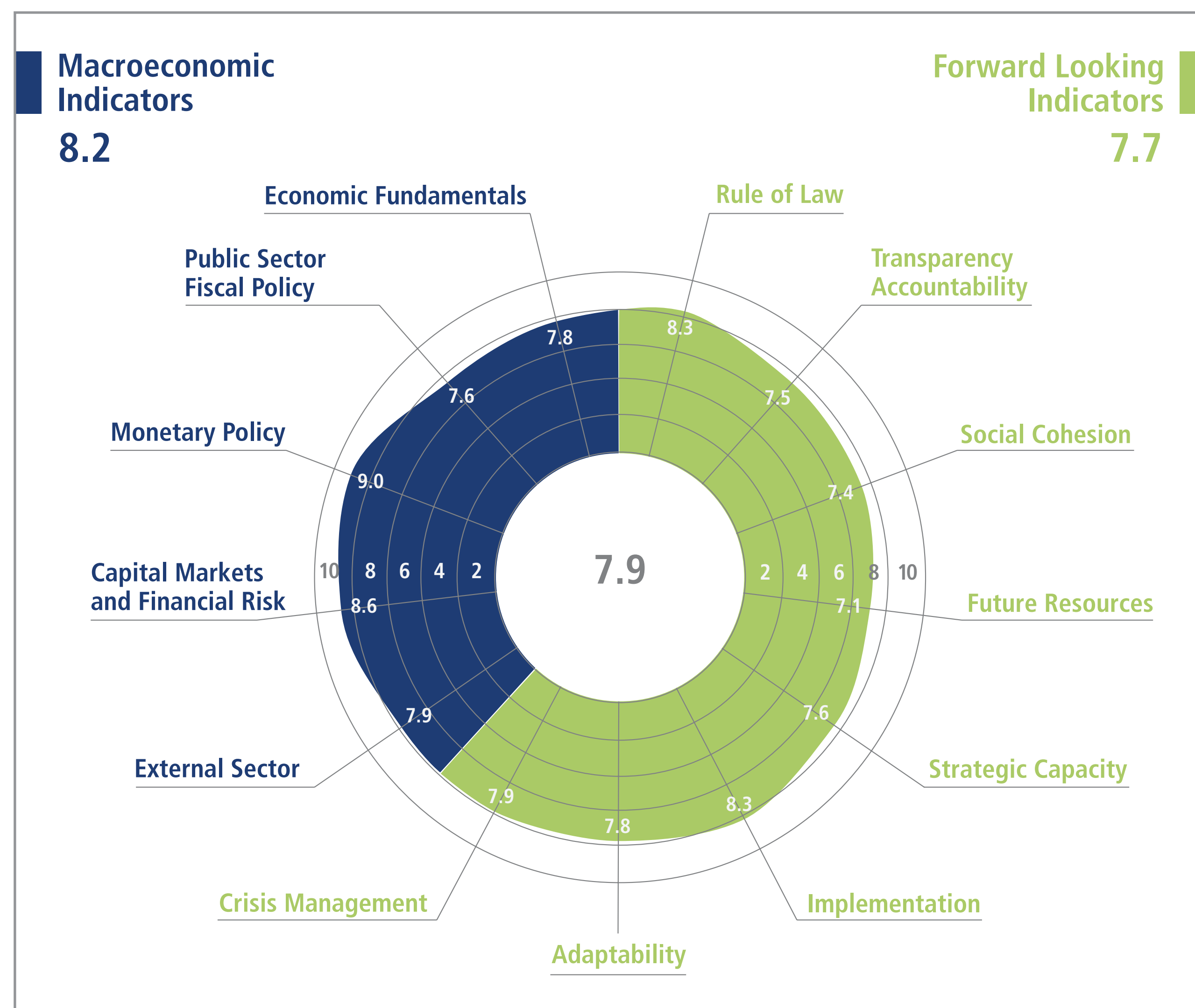
IV. External Sector	2008	2009	2010	2011	2012f
Current Account Balance/GDP (%)	-1.7	-1.5	-2.2	-2.1	-2.6
External Debt/Exports (%)	87.9	111.3	110.2	100.8	109.8
External Debt/FX Reserves (%)	102.4	83.1	89.0	84.7	86.6
M2/FX Reserves	927	817	807	897	896
FX Reserves/Imports (months)	8.5	13.2	11.9	13.4	17.0
Debt Service Ratio/(%)	25.0	34.8	25.9	22.9	18.1
ST External Debt/Total External Debt (%)	18.4	15.6	22.3	13.3	10.2
ST External Debt + MLT Amortization/ FX Reserves (%)	40.0	32.2	35.4	25.4	19.0
FX Reserves (bn US$)	193.8	238.5	288.6	352.0	380.3
External Debt (bn US$)	198.4	198.2	256.8	298.2	329.2

Data Sources: IMF Article IV; Central Bank of Brazil.

f = forecast

FRANCE

RATING: 7.9 (AA+)



Pros:

- Diversified, wealthy and highly productive economy characterized by good performance in research and innovation
- Strong track record of swift decision-making and execution of fiscal policy, underpinned by a highly qualified and competent civil service
- Broad and deep revenue base
- Low interest/revenue ratio
- Strong tradition of rule of law
- Highly developed social safety net

Cons:

- Rapidly rising debt/gross domestic product (GDP) ratio
- Rapidly rising debt/revenue ratios
- Poor real and nominal GDP performance
- Ongoing primary deficits
- Actuarially unsound public retirement schemes
- Significant contingent liabilities emanating from the financial system
- Significant contingent liabilities emanating from eurozone bailout programs

Summary

The French government presides over one of the world's richest countries, both in terms of accumulated assets and ongoing income generation. Given the country's wealth, the government has at its disposal more than adequate resources to meet its financial requirements today and in the future. At the same time, given France's political tradition, the French people have come to expect a wide-ranging social welfare system, which is increasingly costly to maintain in a globalized world. Membership in the eurozone, by definition, constrains public policy actions. Sometimes this is to a country's benefit, while at other times, reduced government flexibility complicates crisis management. For France, at present, this combination of factors results in relatively low sovereign credit risk associated with an AA+ rating. However, as discussed below, France faces important challenges going forward.

The Economy

For a number of years, economic growth in France has been relatively anemic. After declining by 2.8 percent in 2009, real GDP growth has remained weak, averaging only 1.6 percent in 2010-2011. In 2012, GDP growth is likely to be near zero. As the eurozone sovereign debt crisis has deepened, it has triggered recessions in many eurozone-member countries, which are also major trading partners for France, dampening demand for French exports. Overall, the eurozone crisis has caused significant stress, not just on French consumer and business confidence, but also in the French financial sector.

Since French banks hold significant positions in eurozone sovereign debt, any further deterioration in sovereign risk in other member states beyond Greece would represent heightened risk for French banks. Such risk remains an important potential contingent claim on the government.

Labor Market Conditions

Weak economic growth, not surprisingly, has been associated with high unemployment, which reached a rate of 10 percent in 2012. Most observers expect unemployment to rise further as government austerity increases, and as businesses continue to adjust to weaker domestic and international growth. Unemployment poses an even greater social risk because youth unemployment is approximately 25 percent. Unemployment is especially high among immigrants and their children.

France has tried to spread employment more widely by legally limiting hours worked. Unlike Germany's scheme of burden sharing, where workers and employers work together to determine the most efficient way to spread employment among employees, France's government-imposed system has often caused unanticipated inefficiencies. In extremis, the program has on occasion caused jobs to move abroad, particularly in financial services and high tech. Even excluding regulations limiting hours worked, France would still have one of the most highly regulated labor markets according to the OECD. Labor-market rigidities are likely constraining employment growth.

The Current Account: A Measure of Competitiveness

Although a current account balance does not have the same meaning for a country in a monetary union compared to one with an independent currency, the current account for a country in a monetary union can provide a snapshot of a country's overall competitiveness. Early in the last decade, France regularly reported current account surpluses. However, since 2005, the country has regularly recorded annual deficits between 0.5 percent and 2.2 percent of GDP. These deficits are not excessive, but are indicative of a slow but steady deterioration in the country's competitive position. In the past, before the introduction of the euro, France would likely have witnessed a modest depreciation of the French franc, the country's former currency. A depreciation would have compensated for some of the loss of competitiveness caused by the country's strict labor laws and extensive social welfare system. Without the exchange rate as a policy tool, the French government must undertake reforms to address issues of competiveness. This might negatively affect the social safety net and/or be politically unpopular.

Fiscal Policy

When discussing fiscal policy, it is important to make a distinction between advanced industrial countries and emerging market economies. Advanced industrial countries are able to carry much more public-sector debt than emerging market countries. The reason is that wealthy countries usually have deep financial markets at home or easy access to such markets in other countries. Another important distinction is that high-income countries usually have more diversified income streams as well as more accumulated assets, at home or abroad, than emerging market countries. This is one reason that we compare countries to their income peers.

The French government faces a major challenge in that it is committed to reducing the fiscal deficit to 4.5 percent this year and 3 percent in 2013. To date, the government has not been able to eliminate the all-important primary deficit, which excludes interest payments. In 2011, the primary deficit was 2.6 percent.

The 2013 Budget

In September, the government tabled its 2013 budget, one of the most austere budgets ever proposed for France during a period of economic weakness. The government aims to cut €36.9 billion from the deficit, including €12.5

billion in spending cuts (€2.5 billion in healthcare cuts, and €10 billion in cuts across ministries). Individual taxes will rise by €10 billion, and business taxes will also increase by €10 billion. €4.4 billion consists of tax increases previously announced in July 2012.

A risk the austerity program poses is one witnessed elsewhere. With French growth close to either side of zero, cutting the deficit by 1.5 percent of GDP will act as a further drag on economic activity. Since the external sector is not likely to counteract such domestic fiscal drag, it will be difficult for the government to reach its assumed GDP growth rate of 0.8 percent in 2013 and 2 percent in 2014.

One new revenue change is a significant income-tax increase. In the new budget, the government has proposed raising the marginal tax rate to 75 percent for high-income earners, a rate not seen in France in decades. Although the government says that this would be a temporary measure, the near-term impact may be that France will be faced with many high-income individuals simply moving to nearby countries with lower tax rates to avoid the new French tax.

Proposed changes to tax increases affecting small- and medium-size business, in the end, may be altered. This follows an effective public-relations campaign on the part of small business against many of the proposals affecting them.

Lower Retirement Age

After winning the election, the newly elected government changed the retirement age from 62 to 60 for those people who began working at an early age and who can prove they worked for 41 years. The estimated cost of this reform is €700 million in 2013, rising to €2.7 billion in 2017. This was an important part of the Socialist Party's platform.

Lowering the retirement age will not prove too costly in the near term. However, its cost will rise over time. If the government wishes to maintain a lower retirement age, it will have to find adequate revenues or expenditure cuts in other parts of the budget to fund it.

Debt Ratios

France's general government debt/GDP ratio has risen steadily since 2005, when it was 66.4 percent, to 85.2 percent by year-end 2011. In September, the government indicated that the debt/GDP ratio had reached 91 percent. Not only is this higher than many of its peers, but the debt/GDP ratio is expected to continue rising, albeit more slowly, for the foreseeable future.

Contingent Claims

Although deficit figures are important in gauging how high a debt/GDP ratio may become, another important reason for sudden increases in government debt is related to contingent claims suddenly being transformed into real claims. Examples of this are government-funded bailouts of financial institutions or other companies. In the case of France, there is a concern that French banks might need the government to bail them out if the eurozone sovereign debt problem worsens, causing another eurozone sovereign to restructure its debt. Since French banks have sizable sovereign portfolios, a restructuring, similar to Greece's, could prove costly to French banks, and therefore to the government.

Another concern is the growing cost of eurozone sovereign bailouts. If the existing bailout funds (European Financial Stability Facility, EFSF, and the European Stability Mechanism, ESM) are able to obviate the need for further sovereign bailouts, then the French government's debt is containable using ongoing budgetary restraint. However, if the eurozone project requires greater injections of funds than already allocated, then France's contribution would likely push France's debt/GDP ratio to levels consistent with an even lower rating.

Eurozone Contagion

Since the Greek government first faced financial difficulties three years ago, eurozone governments have been plagued with ongoing market-access concerns. As is well known, Greece, Ireland, Portugal, Spain, Cyprus and even Italy, have all faced major bouts of investor angst. In Greece, investors suffered significant losses as Greek government debt was restructured, causing massive losses on principal. Given that background, private sector-investor concern has risen. As a result, interest rates on government securities in the periphery have increased, often times to levels that if sustained would threaten the government's solvency.

France faces two problems caused by the eurozone crisis. The first is that France has already had to contribute to the EFSF and will soon need to fund its portion of the ESM. If Italy and Spain require bailouts, it could prove costly, potentially requiring additional French contributions to any bailouts. The second problem is that although France is viewed by investors as part of the eurozone's core, it is also viewed, in terms of government finance, as one of the weaker members of the core. As such, to keep financial contagion from affecting its own interest rates, the French government must be extra vigilant.

Antecedents to Contagion

What could cause investor concern to rise regarding France? Any sign that the French government is unable to deliver upon its pledge to stabilize its debt over time.

Possible signals include if the government is not able to implement its recently tabled budget or if economic growth is significantly below growth rates assumed in the budget. Since it is possible that the growth assumptions in the budget may prove too optimistic, some observers are already arguing that the French government will need to present a mini-budget in early 2013 to take into account the impact of lower growth.

Consequences of Contagion

The consequences for the French government of a loss in investor confidence would be that interest rates on government debt would rise, making any solution to France's fiscal challenges all the more difficult. Significantly higher interest rates on French government debt would negatively affect the French government's credit rating.

Forward Looking Indicators (FLI)

Given that France is among the most highly developed countries, it is not surprising that France performs well compared to other countries with regard to FLI. It performs especially well in five categories: 1) rule of law; 2) policy implementation; 3) social cohesion; 4) adaptability; and 5) crisis management.

France has a long and well-respected tradition of rule of law. Except for a brief period when the country was occupied in World War II, France has maintained a democratic, law-based system of government since 1870. This has served the country well. France also has a strong tradition of an elite civil service. Being a high-ranking civil servant in France is a mark of prestige. Such a professional and well-qualified civil service is able to implement policies effectively and in a timely manner.

Although France faces a problem with integrating its ethnic and religious minorities, France is a country where nationality is measured by adoption of French cultural norms. As such, despite religious and ethnic divides, French society is more fluid than many other European nations where nationality is often more ethno-centric. This shared sense of cultural identity, despite the presence of large ethnic and religious minorities, leads to greater social cohesion, especially during a crisis.

France clearly has a strong history of adapting to changing circumstances. The country has had five republics plus two empires since the First Republic was proclaimed in 1792. Despite all the political changes in the last 220 years, France has always remained among the world's most economically and politically advanced nations.

The French government scores high marks for crisis management. This is related not only to the competency of its civil service but is also supported by the nature of its presidential system of government. When faced with a crisis, leaders are able to provide timely leadership, with the civil service then able to implement their directives effectively.

French performance is weaker in only two categories: 1) future resources; and 2) strategic capacity. However, in both instances, the weakness centers around the government's challenge in dealing with the rising costs of the social welfare system and policy constraints associated with eurozone membership.

Although French demographics are more favorable than most other Continental European countries, France must still adjust to the coming demographic transition, although France has a longer time horizon to react to its changing demographics than other countries have.

France's eurozone membership poses unique policy challenges. As a member of the eurozone's core, it gains significant advantage regarding government funding in terms of availability and cost. However, as one of the weakest of the key core countries, it is subject to more financial volatility than other core countries with the possible exception of Belgium, a highly indebted government.

On balance, given France's tradition of strong and effective governance, it appears likely that this government and future governments will be able to cope with the country's future challenges.

Recent Political Developments

For more than a decade, the French economy has faced growing pressures caused by: 1) globalization; 2) demands forced upon it by European monetary integration; 3) concerns regarding industrial competitiveness; and 4) ongoing fiscal pressures. As a result, the call for structural reform has been omnipresent across the political spectrum. However, to date, by its own admission, the French government has failed to address these challenges adequately. Despite some reforms in the social security system (mainly pensions) and a few supply-side measures aimed at improving competitiveness, many reforms await implementation.

The last presidential election in France took place earlier this year. The Socialist Party, led by François Hollande, won the second round of the presidential election held on 6 May 2012. In legislative elections held in June, the Socialists and their allies took control of the lower house of parliament. Socialists already had control of the Senate and many regional and local governments. Nevertheless, despite the change in government, there appears to be widespread agreement across the political spectrum on the need to reduce fiscal imbalances through a clear medium-term plan. Although there are significant differences on the mix of policies to achieve this, the rating presumes that fiscal targets will be achieved between 2012 and 2014.

Country Committee Average Scores

MACROECONOMIC INDICATORS	8.2
Economic Fundamentals	**7.8**
Real GDP Growth %	7.0
GDP Per Capita	8.5
Real Exports (% Change)	7.2
Real Imports (% Change)	7.8
Gross Domestic Investment/GDP (%)	8.3
Gross Domestic Savings/ GDP (%)	8.3
Inflation-CPI (%)	8.5
Population Growth (% Change)	6.5
Public Sector / Fiscal Policy	**7.6**
General Government Debt/GDP (%)	7.0
Nominal GDP Growth (Local Currency %)	7.5
General Govt Debt/General Govt Revenue (%)	8.5
General Govt Interest/General Govt Revenue (%)	8.3
General Govt Primary Balance/GDP (%)	6.7
General Govt Fiscal Balance/GDP (%)	7.2
General Govt Revenue/GDP (%)	8.2
General Govt Expenditure/GDP (%)	7.5
Monetary Policy	**9.0**
Accommodative Monetary Policy	9.0
Capital Markets and Financial Risks	**8.6**
Domestic Credit/GDP (%)	9.6
Domestic Credit (% Change)	8.8
Overall strength of banking sector	7.6
External Sector	**7.9**
Current Account	7.9
External Debt	7.9

FORWARD LOOKING INDICATORS	7.7
Political Economic and Social Stability	**7.6**
Rule of Law	**8.3**
Legal Certainty	8.9
Independent Judiciary	9.2
Separation of Powers	7.0
Property Rights	8.3
Transparency / Accountability	**7.5**
Corruption Prevention	7.2
Independent Media	8.0
Civil Society Participation	7.4
Social Cohesion	7.4
Social Inclusion	7.8
Trust in Institutions	7.0
Societal Meditation	7.5
Conflict Management	7.3
Future Resources	**7.1**
Education	7.9
Research and Innovation	7.3
Employment	6.6
Social Security	6.1
Environmental Sustainability	7.6
Steering Capability and Reform Capacities	**7.9**
Strategic Capacity	**7.6**
Prioritization	7.1
Policy Coordination	7.8
Stakeholder Involvement	7.4
Political Communication	8.3

Implementation	8.3
Government Efficiency	8.3
Resource Efficiency	8.3
Adaptability	**7.8**
Policy Learning	7.3
Institutional Learning	8.3
Crisis Management	**7.9**
Historical Evidence of Crisis Management	8.2
Crisis Remediation	7.2
Signaling Process	7.3
Timing and Sequencing	8.2
Precautionary Measures	8.2
Automatic Stabilizers	8.3

FRANCE MACROECONOMIC INDICATORS

I. Economic Fundamentals	2008	2009	2010	2011	2012f
Nominal GDP Growth (Local Currency %)	0.8	-1.5	2.6	3.5	1.2
Real GDP Growth (%)	0.3	-2.5	1.5	1.7	0.5
Real Exports (% Change)*	-0.6	-12.2	9.4	6.4	4.6
Real Imports (% Change)*	0.6	-10.6	8.3	6.5	3.9
Nominal GDP (bn US$)	2,832	2,620	2,549	2,570	2,680
GDP per capita (US$)	43,992	40,477	39,170	39,272	41,295
GDP per capita (PPP basis: US$)	34,041	33,549	34,124	34,000	35,000
Inflation-CPI (%)	3.2	0.1	1.7	2.3	2.0
Population Growth (% Change)	0.56	0.54	0.55	0.55	0.55
Gross Domestic Investment/GDP (%)	21.9	19.0	20.4	20.8	21.2
Gross Domestic Savings/GDP (%)	20.1	17.5	18.6	18.6	19.2

*Exports/Imports include goods only

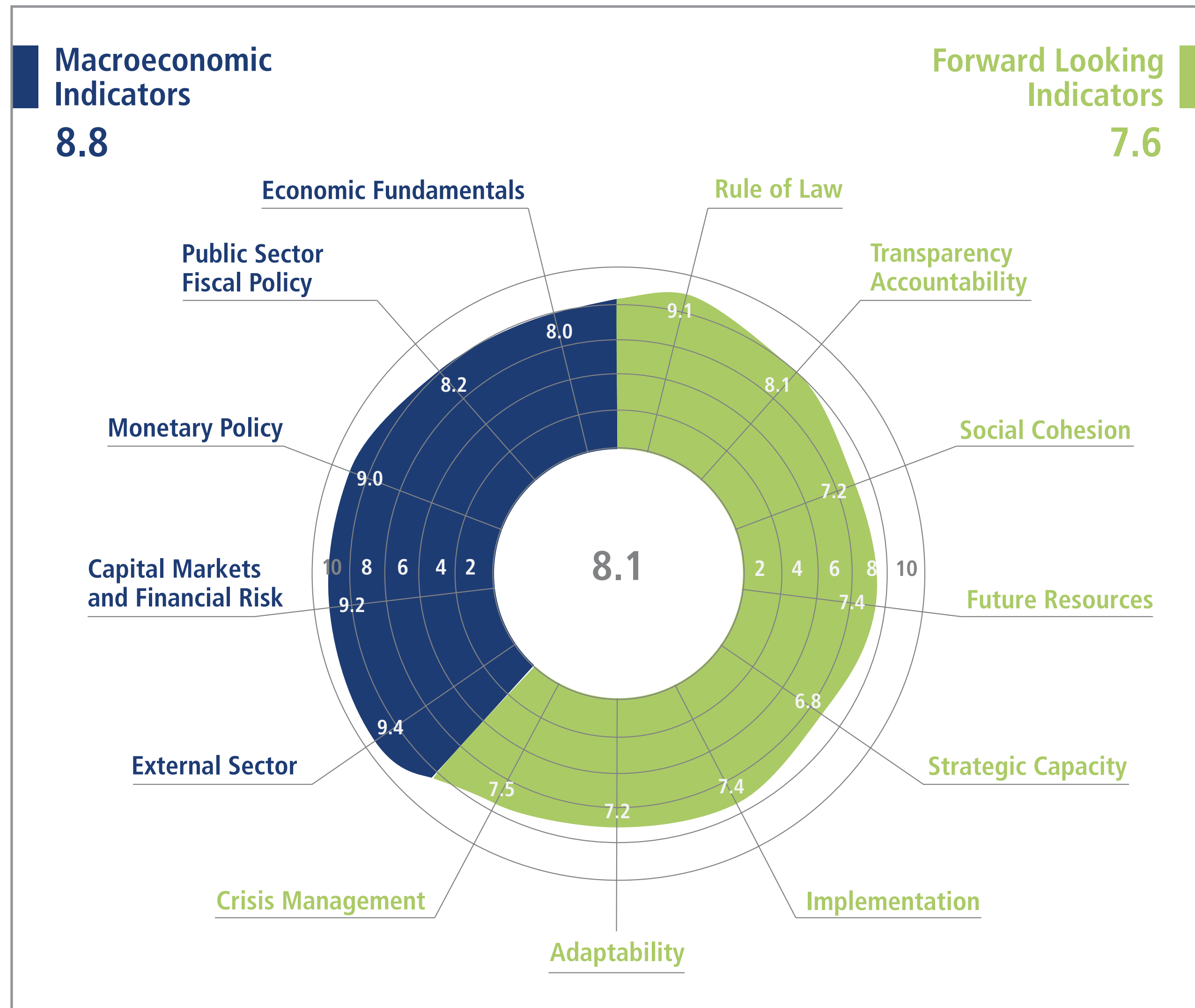
II. Public Sector Policy	2008	2009	2010	2011	2012f
General Government (GG) Debt/GDP (%)	68.2	79.0	82.3	85.2	87.2
GG Revenue/GDP (%)	49.9	48.8	49.7	50.1	50.4
GG Expenditure/GDP (%)	53.2	56.5	56.8	55.9	55.2
GG Financial Balance/GDP (%)	-3.4	-7.7	-7.1	-5.8	-4.8
Primary Balance/GDP	-0.3	-3.2	-3.0	-1.8	-0.9
GG Debt/GG Revenue (%)	136.7	161.9	165.6	170.0	173.0
GG Interest/GG Revenue (%)	5.8	4.9	5.0	5.6	6.0
III. Capital Markets & Financial Risk	**2008**	**2009**	**2010**	**2011**	**2012f**
Domestic Credit (% Change)	1.5	3.6	3.1	3.0	1.0
Domestic Credit /GDP (%)	124.3	128.8	132.1	134.2	135.0
IV. External Sector	**2008**	**2009**	**2010**	**2011**	**2012f**
Current Account Balance/GDP (%)	-1.7	-1.5	-1.7	-2.1	-1.9

Data sources: Banque de France Annual Reports; IMF's Article IV 2012; OECD Annual Reports.

f = forecast

GERMANY

RATING: 8.1 (AAA, Negative Outlook)



Pros:

- World's fourth-largest economy
- Diversified, wealthy and highly productive economy
- Export powerhouse
- Proven track record of swift decision-making and effective execution of fiscal policy, supported by an efficient and competent bureaucracy
- Broad and deep revenue base
- Low interest/revenue ratio
- Strong tradition of rule of law
- Highly developed social safety net

Cons:

- Debt/gross domestic product (GDP) and debt/revenue ratios higher than the historical norm
- Significant contingent liabilities emanating from eurozone bailout programs
- Significant contingent liabilities emanating from the financial system
- Declining and aging population

Summary

Germany is the world's fourth-largest and Europe's largest economy. Germany is one of the world's most competitive, diversified, wealthy and productive nations. Its recovery from the Great Recession was one of the strongest among the world's advanced countries. Such good performance was all the more exceptional given the sovereign-debt crisis, which has loomed over Europe for the last three years.

Despite the suddenness of the reunification of East and West Germany in the early 1990s, the peaceful nature of the integration process clearly demonstrated the country's capacity to deal effectively with demanding and unexpected socioeconomic and financial problems. Although some have criticized a number of the policies adopted during the reunification process and despite some missteps, the country and the democratic traditions characteristic of West Germany not only survived, they flourished.

Germany has a mature and highly developed welfare state, which guarantees a high subsistence level to all citizens. The rate of poverty is low even by West European standards. In the medium term, although Germany will have to deal with a demographic transition deeper than many other advanced industrial countries, the country's willingness to accept immigrants, and the attractiveness of the economy to potential immigrants, may slow the demographic transition more than for countries less attractive or welcoming to new immigrants.

The major problem facing the German government today is the eurozone. Many analysts argue that the eurozone was created to guarantee that a united Germany would remain anchored in Western Europe and not be tempted to focus its energies on its eastern neighbors. This has certainly proved to be the case. However, that anchor represents a heavy burden indeed.

Another problem Germany faces is that the cost of financial integration may be so big that it becomes politically unacceptable to the German electorate. Deeper fiscal integration would most likely be built on the expectation that Germany would be the main gaurantor of solvency within the eurozone. For instance, contingent liabilities emanating from Germany's required share of eurozone bailouts of national governments or eurozone-wide banks (once a European bank supervisor is in place) represent the single greatest downward pressure on the German government's AAA rating. Given the weakness seen in a number of eurozone economies, the concern is that what are today contingent liabilities may become actual liabilities.

The Economy

The German economy's recovery from the recession was among the best of the major western economies. Germany recorded real GDP growth of 3.6 percent in 2010, followed by 3.1 percent in 2011. However, by late 2011, growing eurozone financial-market instability and slowing demand for German exports resulted in a broad-based retrenchment in most sectors. By 3Q12, activity picked up, fueled by a recovery in external demand and consumption. At present, there are concerns that the German economy may again be experiencing a slowdown in growth as its main trading partners in Europe experience slow growth or an outright recession. In 2012, real GDP growth is expected in the 1 to 1.5 percent range, below Germany's long-term potential.

Inflation

Germany's inflation as measured by Eurostat's Harmonized Index of Consumer Prices (HICP) remained relatively low from 2009 to 2011, albeit on an upward trajectory. In 2009, Germany's HICP rose by 0.8 percent. That was followed by a rise of 1.9 percent in 2010, and a further increase to 2.3 percent in 2011. Inflation year-over-year (yoy) was yet higher in early 2012. In January and February, inflation was recorded at between 2.8 and 2.9 percent. Since then, inflation has moderated. During the six months ending in September, monthly inflation yoy ranged between 1.9 and 2.3 percent. This poses a potential policy dilemma for the European Central Bank (ECB). Since a number of eurozone countries are already in recession, low interest rates and the use of unorthodox monetary-policy tools, such as sovereign bond buying, would seem to pose little near-term inflation risk. However, since German growth is still positive, albeit not as high as in 2010-2011, an easy monetary policy, especially sovereign-bond buying, may trigger higher German inflation down the road. In other words, what is good for the eurozone overall might not be ideal for Germany itself.

Labor Market Conditions

For much of the 1990s and for most of the last decade, Germany suffered from a relatively high rate of unemployment. In fact, the average unemployment rate during the last 20-plus years topped 9 percent. In March 2005, unemployment peaked at 12.1 percent. To deal with what had obviously become a structural problem, the German government in 2002, under Social Democratic Party (SPD) leader Chancellor Gerhard Schröder created a commission to explore how to reform Germany's labor markets. The commission proposed numerous reforms. These reforms are generally known as the Hartz reforms – named after the head of the commission, Peter Hartz, then the director of human resources at Volkswagen. The proposals were grouped into four main sets of reforms.

The core of these reforms combines unemployment benefits and social-welfare benefits into one package called Hartz IV.

The Hartz reforms improved training. Entrepreneurs received subsidies for creating jobs. In general, labor markets were made more flexible. Labor-market incentives were changed. For instance, government unemployment assistance became means-tested. In addition, in return for assistance, depending on circumstances, the unemployed were required to set employment-related goals in the form of a labor contract. These reforms were implemented by the government and backed by the corporate sector and the labor unions. This consensus among social partners has been one of Germany's greatest strengths. It helped Germany increase its price competitiveness in the early '00s. Germany has also introduced new "tools" that helped manage and decrease unemployment. Primary among them are "short-term labor" (*Kurzarbeit*) programs and "working-time accounts" (*Arbeitszeitkonten*).

All in all, these reforms have allowed German labor markets to remain resilient during the ongoing eurozone crisis, while most of the rest of the eurozone is battling record unemployment. In September, Germany's unemployment rate was 6.8 percent, up marginally from a low of 6.4 percent in November 2011. Despite this slight increase in the unemployment rate in recent months, Germany's unemployment rate is far lower than in other eurozone countries. The average rate of unemployment in the eurozone in September was 11.6 percent.

The Banking Sector

The banking sector suffered large losses from impaired assets and had to be rescued by a hefty government injection of funds. In October 2008, the German government passed a law – in record time – setting up the Special Fund for Financial Market Stabilization (Soffin). The fund was authorized to provide €480 billion in support using a combination of loan guarantees and capital injections to support the banks and the overall financial system. Since then, the banking system has been significantly strengthened but some weaknesses remain. Earlier this year, to allay concerns regarding the ongoing sovereign-debt crisis and its impact on banks, the German government passed a law extending Soffin until the end of 2012. In general, German banks today have more than enough liquidity, and their capitalization is sufficient. The interbank market has recovered, and banks take fewer resources from ECB liquidity operations. However, the quality of the banks' capital and profitability is considered low by some analysts, while their leverage ratios remain high.

A few of the larger banks need to strengthen their capital, following the latest European Banking Authority's (EBA) stress test. They are addressing the issue. At the same time, one of biggest banking-sector problems still facing policymakers over the medium term is the politically sensitive question of the troubled *Landesbanken* sector.

The External Sector

The current account surplus remained large at 5.7 percent of GDP in 2011 and an expected 5.2 percent in 2012, compared to an average 6.4 percent in the period 2007-2010. In general, however, current account surpluses among eurozone members are shrinking while those of countries outside the currency union are rising. The trade surplus continues to account for the bulk of the current account surplus. The services account deficit has been declining steadily since 2006. At the same time, Germany has witnessed a rising net income surplus. Net income represents a steadily rising share of the overall current account surplus.

Public Sector and Fiscal Issues

When discussing fiscal policy, it is important to make a distinction between high-income and mid-income countries. High-income countries are able to carry much more public-sector debt than mid-income countries. The reason for this is that wealthy countries usually have deep financial markets at home or easy access to such markets abroad. Another important distinction is that high-income countries usually have more diversified income streams as well as more accumulated assets, at home or abroad, than mid-income countries. This is one reason that we compare countries to their income peers. It is worth nothing that the financial crisis has shown that there are no *risk-free* assets for any country

Debt/GDP Ratio

The German government faces a major challenge in that general government debt increased substantially in 2009-2010. The increase was caused by a combination of factors. Ongoing financial deficits represented one reason for the increase, but more importantly, the debt rose as a result of the financial-sector bailout. The general government debt/GDP ratio increased to almost 74.7 percent in 2009 and to 83 percent in 2010. The government quickly undertook a major fiscal-consolidation program. As a result, a primary deficit of 1.8 percent in 2010 was turned into a primary surplus of 1.6 percent of GDP in 2011. A return to primary surplus had an obviously beneficial impact on the financial balance. From a deficit of 4.3 percent of GDP in 2010, the deficit was reduced to 1 percent in 2011. Not surprisingly, the debt/GDP ratio declined slightly in 2011 to 81.2 percent. Reflecting slightly lower economic growth in the first half of 2012, the debt/GDP ratio had risen slightly to 82.2 percent by mid-year. The general government debt to GDP ratio is likely to remain above 80 percent over the next several years.

Constitutional Amendment Limits Deficits

The government proposed a four-year program for 2012-2016 that would cut deficits by over 3 percent of GDP, more than half of which will come from spending cuts. The proposed program follows the requirements of a 2009 constitutional amendment introducing the *Schuldenbremse* or debt brake. The new amendment will limit federal government structural deficits to 0.35 percent of GDP by 2016. By 2020, German *Länder* (states) will not be allowed to have structural deficits. Given Germany's past track record on meeting fiscal targets, it is likely that the country will easily be able to meet these goals. Exceptions to the targets include a natural disaster or a severe economic downturn/shock.

Excluding event risk emanating from potential eurozone or bank bailouts, the most significant risk facing Germany's medium-term fiscal outlook is the demographic transition. Despite its willingness to accept immigrants, the country's population already started registering slight declines in 2007. Social security spending already accounts for about 20 percent of GDP, almost equally divided between pensions and health care. Recent pension reforms have strengthened the system going forward by increasing the retirement age. The larger problem relates to ever-rising health costs, an international phenomenon.

Forward-Looking Indicators (FLI)

When evaluating FLI, Germany's position among the most highly developed countries means that it performs well compared to other countries. It performs especially well in four categories: 1) rule of law; 2) transparency and accountability; 3) policy implementation; and 4) social cohesion.

Rule of Law

By far, the strongest category was rule of law. Property rights, contracts and the independence of the judiciary all supported a high score. In general, the German legal system and the administrative apparatus are viewed as predictable and impartial. Given Germany's unique history, there is great sensitivity to maintaining strong democratic institutions. The German Federal Constitutional Court, or Germany's supreme court, is an effective guardian of the country's constitution, having the authority and track record of striking down laws deemed unconstitutional.

Transparency and Accountability

German political institutions are open to public scrutiny. The division of powers is complex, and has evolved over time. For instance, as recently as 2006, the German government changed the role of the Bundesrat, Germany's upper house, which represents the *Länder*. The reform was undertaken to streamline and clarify the decision-making process.

One of the interesting challenges facing Germany is that decision-making is incrementally moving to eurozone-wide institutions. For example, the Bundesbank, the country's central bank, is also one of the country's most respected institutions. However, now that the Bundesbank has become just one central bank among 17, its power and, as such, its accountability have been severely diminished. Two of the country's traditionally most important policy areas, monetary and exchange-rate policy, have been ceded to a supranational body. Similar developments will likely emerge in other areas as eurozone integration increases.

Policy Implementation

The German government is recognized as having one of the world's most efficient bureaucracies. Senior civil servants are considered competent, especially when compared globally. The bureaucracy follows policy guidelines set out by the legislative and executive branches of government.

Social Cohesion

Social cohesion is fairly strong as evidenced by the highly developed nature of the country's social welfare system. A minimum standard of living is guaranteed by the constitution. At the same time, the country's social cohesion is challenged by its sizable minority population, which is composed of relatively recent immigrants and their German-born children. However, given Germany's history, the country is particularly sensitive to this issue, and has handled it better than most of its European counterparts.

Germany scored lower in two categories: 1) strategic capacity and 2) adaptability. Before exploring these two issues, it should be noted that even in these two categories, Germany scored quite well compared to other countries.

Strategic Capacity

The main weakness relates to the existence of coalition and grand-coalition governments, which comprise representatives of a broad political spectrum. Although the willingness to undertake grand coalitions when necessary is an overall strength, setting out long-term strategic priorities in such an environment has often proved challenging. In addition, even in coalitions of similar political parties, discordant cabinet voices are heard far more frequently in Germany than in the UK or Canada, countries with a different parliamentary tradition.

A difficult task for any coalition government is to guarantee a coherent communication policy. The constant tendency of a coalition partner to sharpen its own profile explains an occasional dissonant communication policy. Government decisions are regularly explained to the public as compromises that do not perfectly satisfy either side

in the coalition. Regardless, it is important that different perspectives are debated in public, and Germany's communication policy does not deny that different views exist between or even within coalition parties.

Adaptability

Another area where Germany scored slightly weaker was in adaptability. It appears an important reason for this relative weakness ironically relates to the competency of the country's bureaucracy. Given general success, there is less incentive, unless forced by circumstance, to learn new means to the same end.

Demographic change and an aging population present long-term challenges to the labor market and the fiscal sustainability of pension, health and long-term care insurance. However, reform policies in the last decade have paid heavy attention to demographic change. As a consequence the German government has been able to realize significant reforms (Hartz reforms, new constitutional debt brake, pension reform with built-in demographic adjustment factors). These are important examples where German governments clearly work towards long-run societal objectives even if this is not popular (Hartz reform, higher pension age). Germany is again gaining attractiveness as an immigration destination in recent years; in 2011, Germany had positive net migration of 279,207. Immigration may help offset demographic change in the medium and long term.

Recent Political Developments

Bundestag or parliamentary elections were last held in September 2009. The Christian Democratic Union/Christian Social Union (CDU/CSU) won the largest number of seats, 239 out of 622. The CDU/CSU was able to form a coalition government with the support of the Free Democratic Party (FDP), which won 93 seats. CDU leader Angela Merkel leads the CDU/CSU/FDP government. Chancellor Merkel first took office in 2005, when she headed a grand coalition that included the Social Democrats (SPD). New elections are required in 2013.

The current government's term in office has been spent mainly dealing with the eurozone's financial crisis, which was caused, in particular, by lax oversight since 2003 of the eurozone's stability and growth pact. This, in turn, brought to the fore the main shortcoming of the eurozone, namely incomplete fiscal and political union. What has now become a chronic crisis has tended to be dealt with on an ad hoc basis. Political feasibility, not fiscal sustainability, has usually been the watchword. Major disagreements exist within the coalition regarding the overall strategy needed to deal with the eurozone crisis. In particular, the impact on Germany of various strategic approaches to the euro is being vocally debated to a point where such debates are increasingly acrimonious.

Recently, with Germany's ratification in September, the European Stability Mechanism (ESM) was established. Ratification was delayed until Germany's Constitutional Court decided whether to grant an immediate injunction, which would have blocked ratification. Since the court did not do this, but rather indicated it will examine the constitutionality of the ESM in the future, the German government was able to ratify the ESM agreement. If everything goes according to plan the ESM will be supported on a European level by a fiscal compact and a banking union. Therefore, despite often strong exchanges among politicians and government officials, the German political system again proved capable of carrying out significant but controversial reforms.

Country Committee Average Scores

MACROECONOMIC INDICATORS	8.8
Economic Fundamentals	**8.0**
Real GDP Growth %	7.6
GDP Per Capita	8.6
Real Exports (% Change)	9.4
Real Imports (% Change)	8.4
Gross Domestic Investment/GDP (%)	7.8
Gross Domestic Savings/ GDP (%)	9.3
Inflation-CPI (%)	7.9
Population Growth (% Change)	5.3
Public Sector / Fiscal Policy	**8.2**
General Government Debt/GDP (%)	7.8
Nominal GDP Growth (Local Currency %)	8.6
General Govt Debt/General Govt Revenue (%)	8.4
General Govt Interest/General Govt Revenue (%)	8.8
General Govt Primary Balance/GDP (%)	7.5
General Govt Fiscal Balance/GDP (%)	8.1
General Govt Revenue/GDP (%)	8.4
General Govt Expenditure/GDP (%)	7.7
Monetary Policy	**9.0**
Accommodative Monetary Policy	9.0
Capital Markets and Financial Risks	**9.2**
Domestic Credit/GDP (%)	10.0
Domestic Credit (% Change)	9.3
Overall strength of banking sector	8.4
External Sector	**9.4**
Current Account	9.6
External Debt	9.3

FORWARD LOOKING INDICATORS	7.6
Political Economic and Social Stability	**7.9**
Rule of Law	**9.1**
Legal Certainty	8.8
Independent Judiciary	9.6
Separation of Powers	8.9
Property Rights	9.2
Transparency / Accountability	**8.1**
Corruption Prevention	8.0
Independent Media	8.4
Civil Society Participation	7.8
Social Cohesion	**7.2**
Social Inclusion	7.0
Trust in Institutions	6.9
Societal Meditation	7.5
Conflict Management	7.3
Future Resources	**7.4**
Education	6.9
Research and Innovation	7.8
Employment	7.7
Social Security	7.3
Environmental Sustainability	7.5
Steering Capability and Reform Capacities	**7.2**
Strategic Capacity	**6.8**
Prioritization	6.4
Policy Coordination	7.1
Stakeholder Involvement	7.2
Political Communication	6.3
Implementation	**7.4**
Government Efficiency	7.8
Resource Efficiency	7.0
Adaptability	**7.2**
Policy Learning	6.8
Institutional Learning	7.6
Crisis Management	**7.5**
Historical Evidence of Crisis Management	8.1
Crisis Remediation	7.1
Signaling Process	6.4
Timing and Sequencing	7.1
Precautionary Measures	8.3
Automatic Stabilizers	8.3

GERMANY MACROECONOMIC INDICATORS

I. Economic Fundamentals	2008	2009	2010	2011	2012f
Nominal GDP Growth (Local Currency %)	1.6	-4.0	4.2	3.9	3.0
Real GDP Growth (%)	0.8	-5.1	3.6	3.1	1.0
Real Exports (% Change)	8.8	-23.7	11.8	16.1	6.5
Real Imports (% Change)	11.5	-22.9	13.3	18.0	7.5
Nominal GDP (bn US$)	3,624	3,299	3,259	3,571	3,644
GDP per capita (US$)	44,132	40,275	39,852	43,689	44,547
GDP per capita (PPP basis: US$)	33,829	32,176	33,414	37,100	39,000
Inflation-CPI (%)	2.8	0.2	1.2	2.5	2.2
Population Growth (% Change)	-0.19	-0.25	-0.15	-0.06	0.0
Gross Domestic Investment/GDP (%)	18.6	17.2	17.5	18.2	17.9
Gross Domestic Savings/GDP (%)	24.8	23.2	23.6	23.9	23.2
II. Public Sector Policy	**2008**	**2009**	**2010**	**2011**	**2012f**
General Government (GG) Revenue/GDP (%)	44.0	44.9	43.6	44.6	44.5
GG Expenditure/GDP	44.0	48.1	47.9	45.6	45.1
GG Primary Balance/GDP (%)	1.6	0.8	-0.1	1.0	0.6
GG Financial Balance/GDP (%)	0.0	-3.2	-4.3	-1.0	-0.9
GG Debt/GDP (%)	66.9	74.7	83.5	81.2	82.2
GG Debt/GG Revenue (%)	152.0	166.4	191.5	182.1	184.7
GG Interest/GG Revenue (%)	6.2	6.0	5.7	6.0	5.4

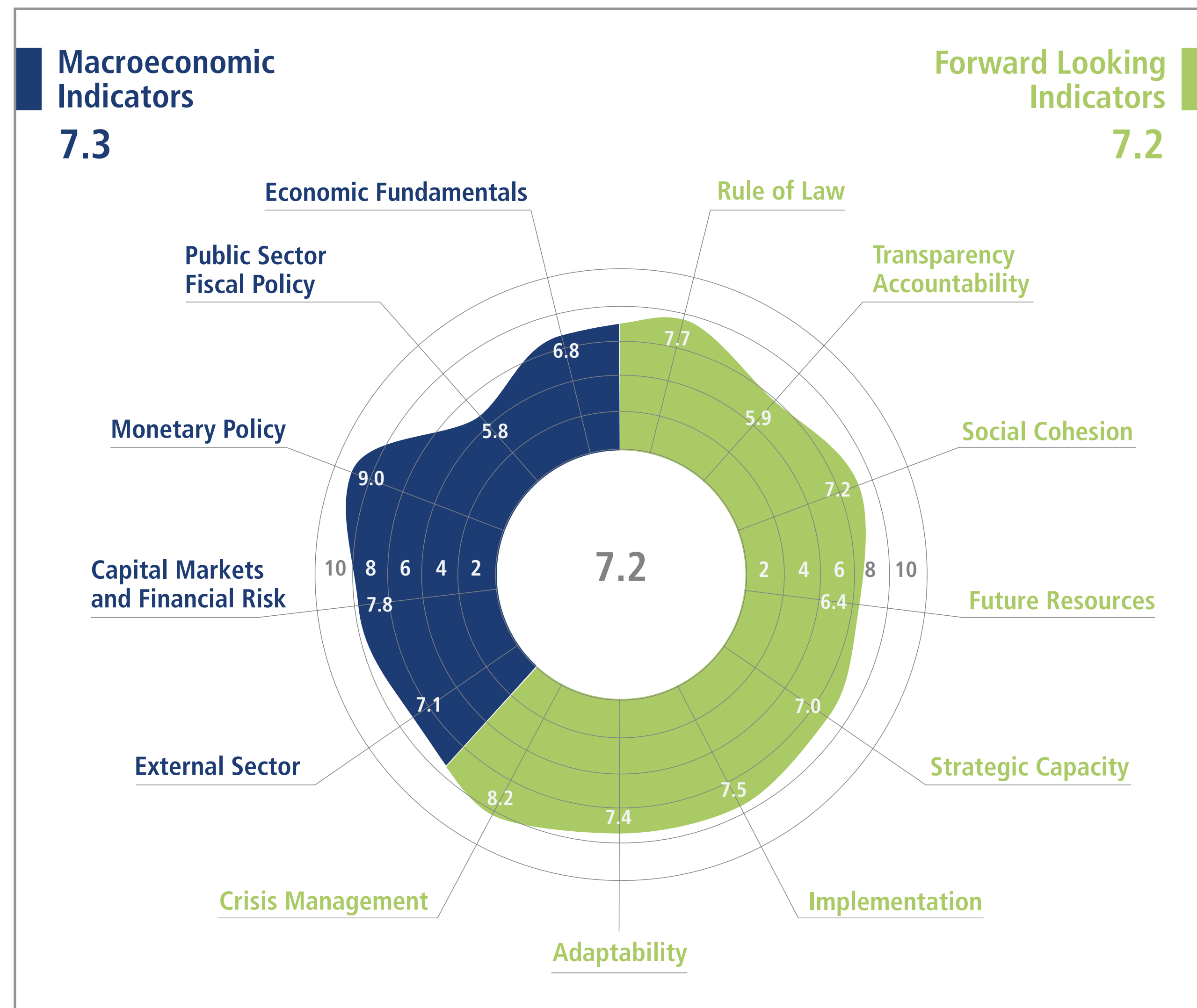
III. Capital Markets & Financial Risk	2008	2009	2010	2011	2012f
Domestic Credit (% Change)	1.6	5.1	-0.8	-4.6	-1.5
Domestic Credit/GDP (%)	126.6	133.1	132.0	125.9	125.0
IV. External Sector	**2008**	**2009**	**2010**	**2011**	**2012f**
Current Account Balance/GDP (%)	6.2	5.9	6.1	5.7	5.2
External Debt/Exports (%)	294.2	370.4	341.2	297.2	300.0

Data Sources: World Bank 2012 World Development Indicators; OECD Economic Outlook; IMF Germany 2012 Article IV Consultation; IMF World Economic Outlook 2012.

f = forecast

ITALY

RATING: 7.2 (AA-)



Pros:

- One of the largest economies in the world
- High per capita income
- Traditionally high personal savings rate
- Dynamic small- and medium-sized enterprise (SME) sector
- Flexible political system able to cope with crises
- Modest primary surpluses
- Broad and deep revenue base
- Strong tradition of rule of law
- Highly developed social safety net

Cons:

- High government debt/gross domestic product (GDP) ratio
- High debt/revenue ratio
- World's third largest public sector debt
- Ongoing, massive refinancing needs
- Poor growth for more than 10 years
- Fiscal austerity exacerbating recessionary tendencies
- Significant contingent liabilities emanating from the financial system
- Significant contingent liabilities emanating from eurozone bailout programs

Summary

Italy is among the world's richest countries in terms of accumulated assets and ongoing income generation. Since Italy joined the eurozone as a founding member in 1999, its economy has, on average, underperformed. One explanation for this underperformance is the loss of Italy-specific exchange rate flexibility. In the pre-eurozone period, an economic crisis inevitably triggered a significant depreciation of the Italian lira, the country's former currency. Lira depreciation allowed the Italian economy to adjust relative prices, vis-à-vis the world, through the exchange rate rather than solely through structural reform. This enabled Italian governments to undertake major structural reforms, but at a pace in tune with the ability of its civil society to adjust. For instance, the Italian government made major reforms to the pension system in the mid-1990s, which in the long run will make it a defined-contribution scheme rather than a defined-benefit program. This innovation puts Italy far ahead of most of its advanced industrial peers. In addition, more recently the government has tied the retirement age to longevity, another reform well ahead of its peers.

Given the country's wealth, the government has at its disposal a significant revenue base. Besides traditional revenue-increasing measures, the government has introduced data-gathering systems aimed at reducing the high rate of tax evasion, an innovation that will continue. However, the fundamental problem the government faces is dealing with the country's large public-sector debt, which predates not only the worldwide financial crisis, but also the creation of the euro.

In the 1990s, the government was able to reduce the government debt/GDP and debt/revenue ratios. However, since the onset of the financial crisis and the subsequent eurozone crisis, these ratios are again at levels not seen since the early 1990s. Therefore, despite maintaining a primary surplus, the government is faced with concerns about its ability to fund itself.

Membership in the eurozone, by definition, constrains public-policy actions. Sometimes this is to a country's benefit, while at other times, reduced government flexibility complicates economic management. In the case of Italy, it has greatly complicated not just its fiscal problems, but it has made it more difficult for real incomes to rise on a sustained basis. As noted above, joining the eurozone caused the economy to lose one of its most powerful policy tools, depreciation of the lira.

In the end, despite the difficulties facing the Italian government, given its long tradition of effective crisis management, as well as its long experience with carrying a large public-sector debt, Italian government credit risk appears manageable as long as eurozone governance remains robust.

The Economy

Italy was hit hard by the economic crisis. The economy shrank by 6.7 percent in 2008-2009. The economy came out of recession in 2010-2011, but it grew by only a modest 1.8 percent and 0.4 percent, respectively. However, when we examine GDP growth year-over-year (yoy), the Italian economy has been contracting at an ever-faster rate. After declining by 0.5 percent yoy in 4Q11, GDP fell by 1.4 percent yoy in 1Q12 and by 2.5 percent yoy in 2Q12. This decline in output is due to a combination of ongoing fiscal consolidation and the deteriorating European economic environment. Overall, GDP growth is forecast to decline by 2.5 percent for all of 2012, with another 0.2 percent decline forecast for 2013. However, given the worldwide economic slowdown, which is now accelerating, that 2013 prediction is probably optimistic.

Medium–term growth recovery hinges heavily on the success of implementing recently initiated structural reforms that aim to restore Italy's past economic dynamism and productivity, as well as on world economic conditions. Successful implementation of fiscal, labor and energy reforms could underpin relatively robust growth. In particular, the return to growth and improved functioning of the labor market might help to reduce the rapidly rising unemployment rate.

Labor Market Conditions

Unemployment has increased from 8.4 percent in August 2011 to 10.7 percent in August 2012, the highest level in more than a decade, but still lower than during the crisis of the 1990s. Given the ongoing contraction in GDP, unemployment is expected to surpass 11 percent before year-end.

Italy is also faced with high youth unemployment, which in August reached 34.5 percent. However, the country has a long history of high youth unemployment. For instance, in the mid 1990s, youth unemployment was around 33 percent. In the 1980s, it also regularly exceeded 30 percent. Given this history, youth unemployment appears to be politically more acceptable in Italy than elsewhere in the eurozone.

Inflation

Inflation is not particularly burdensome for Italy at present since a portion of the inflation rate is due to one-off factors. The most recent measures of the consumer price index (CPI) indicate that it was between 3.1 and 3.3 percent, depending on which CPI measure is used. The lower rate is based on the Italian CPI market basket, and the 3.3 percent figure is based on the EU harmonized rate. Another one-off factor causing higher inflation relates to higher indirect taxes.

The Banking System

Italy's banks are deeply intertwined with the government. The key risk faced by Italian banks is eurozone sovereign risk, in particular, Italian government sovereign risk. In August 2011, Italian banks held €212 billion of Italian government securities. By August 2012, that had risen to €316 billion. If the Italian government has a problem, Italian banks will be under significant stress. Italy's financial system has increasingly weakened during the crisis, with non-performing loans (NPLs) to total loans ratio rising to almost 11.7 percent at the end of 2011, up from 4.6 percent at the end of 2007. Moreover, Italian bank exposure to Greece, Portugal, Ireland, Spain and Cyprus, as well as Italy's own government, render Italian banks vulnerable to any further deterioration in eurozone sovereign credit risk. As discussed below, the banking system represents an important contingent liability for the government.

The Current Account: A Measure of Competitiveness

Although a current account balance does not have the same meaning for a country in a monetary union compared to one with its own currency, the current account for a country in a monetary union can provide a snapshot of a country's overall competitiveness. When Italy had its own currency, the current account frequently seesawed from surplus to deficit to surplus. These fluctuations were caused by changes in domestic demand and exchange-rate fluctuations. In the late 1990s, Italy recorded several years of current account surpluses. However, except for 1999, the year Italy joined the eurozone, the country has regularly recorded annual current account deficits between 0.3 percent and 3.6 percent of GDP. These deficits are not excessive, but indicate a steady deterioration in the country's competitive position. In the past, before the introduction of the euro, Italy would likely have witnessed a depreciation of the lira. Such a depreciation would have compensated for some of the loss of competitiveness caused by the country's strict labor laws and byzantine regulatory environment. A depreciation would have also curtailed the demand for imports. Without the exchange rate as a policy tool, the Italian government and Italian business have been forced to address issues of competitiveness head on. This has and will require reforms, which have been and are highly unpopular and difficult to implement. They have been so difficult to implement that Italy was forced to adopt a technocratic government to enact unpopular austerity measures and economic reforms required to deal with Rome's funding crisis.

Fiscal Policy

When discussing fiscal policy, it is important to make a distinction between advanced industrial countries and emerging market economies. Advanced industrial countries are able to carry much more public-sector debt than emerging market countries. The reason is that wealthy countries usually have deep financial markets at home or easy access to such markets abroad. Another important distinction is that high-income countries usually have more diversified income streams as well as more accumulated assets, either at home or abroad, than emerging market countries. This is one reason we compare countries to their income peers.

Italian Government Debt

Italy's general government debt, measured in absolute and relative terms, is very high. It stood at 120 percent of GDP and 257.7 percent of revenue at the end of 2011. However, since the Italian government has been faced with a triple digit debt/GDP ratio for decades, it has grown adept at managing the debt. Given that the debt has been high for so long, the government recognized long ago that fiscal reforms were needed, especially in its pension system. As a result, despite the fact that Italy has only moved slowly when addressing most socially contentious issues, the government has been able to tackle the country's long-term pension problem, something not yet accomplished by governments in Germany, France or the US. Given a general government debt in excess of €2 trillion, it is not surprising that annual amortizations are high, requiring uninterrupted market access.

Primary Surpluses and Ongoing Financial Deficits

Despite the government's regularly running primary surpluses, the country still faces financial deficits caused entirely by interest payments. Interest payments to revenue increased to 10.1 percent in 2011. Although this ratio is high compared to many of Italy's peers, it must be remembered that this ratio is less than half what it was during the mid-1990s. Also, even if interest rates remained elevated, given the maturity structure of the debt, it would take years for the average interest rate on Italian government debt to rise significantly.

Fiscal Consolidation Under Monti

The ongoing fiscal consolidation, initiated by the Monti government, has been impressive. The primary balance, after a short period of deficit, moved back to surplus. The government's near-term fiscal program has been ambitious. In December 2011, the government approved new austerity measures reducing the deficit by €30 billion through a combination of tax increases and spending cuts. In August, the government won a confidence vote after an extra €4.5 billion in spending cuts was passed. Although the government indicated in April that a balanced budget was no longer likely in 2013, in recent weeks the Italian prime minister indicated that he will still aim for what he calls a structurally balanced budget by 2013, which apparently means within 0.5 percent of balance. Given the intensifying slowdown in world growth, this will probably be difficult if not impossible to achieve. The IMF recently forecast that the Italian government's deficit in 2012 will be 2.6 percent, well above the government's forecast of 1.6 percent. For 2013, the International Monetary Fund (IMF) forecasts a deficit of 1.5 percent, while the government is aiming for a near-balanced budget. Nonetheless, given the sizable parliamentary majorities, which have voted in favor of austerity, it is likely that even after next April's parliamentary elections, a future Italian government will probably not deviate too far from the present course. Earlier this year, Italy's constitution was amended to require balanced budgets beginning in 2014. Although not airtight, the new amendment will make it more difficult for future governments to incur significant deficits.

Contingent Claims

Although deficit figures are important in gauging how high a debt/GDP ratio may become, government debt can also suddenly increase when contingent claims suddenly transform into real claims. Examples of this are government-funded bailouts of financial institutions or other companies. In the case of Italy, there is a concern that banks might need the government to bail them out if the eurozone sovereign-debt problem worsens. Only recently, the government was forced to intervene in what is often called Europe's oldest bank, Monte dei Paschi di Siena. Since Italian banks have sizable sovereign portfolios, another restructuring similar to Greece's could prove costly to Italian banks, and therefore to the government.

Another concern is the growing cost of eurozone sovereign bailouts. If the existing bailout funds (Euopean Financial Stability Facility, EFSF, and the European Stability Mechanism, ESM) prevent further sovereign bailouts, and move any bank bailouts in the future to the eurozone level, then the Italian government's debt is sustainable if strict budgetary discipline is followed. The recent balanced budget amendment makes that more likely. However, if the eurozone project requires greater injections of funds than already allocated, then Italy's contribution to these bailouts would likely push its debt/GDP ratio to levels consistent with a lower rating.

Eurozone Contagion

Since the Greek government first faced financial difficulties three years ago, eurozone governments have been plagued with ongoing market-access concerns. As is well known, Greece, Ireland, Portugal, Spain, Cyprus and even Italy have all faced major bouts of investor angst. In Greece, investors suffered significant losses as Greek government debt was restructured, causing massive losses on principal. Given that background, private-sector investor concern has risen. As a result, interest rates on government securities in the periphery have increased, often to levels that if sustained would threaten the government's solvency.

Antecedents to a Loss in Investor Confidence

What could cause investor concern about Italy to rise further? Any sign that the Italian government is unable to deliver upon its pledge to balance its budget would do it. According to the new constitutional amendment, the government is required to balance its budget by 2014. However, under existing assumptions, the IMF has estimated that the Italian government might not have a balanced budget before 2018 at the earliest. If the IMF is correct in its forecast, then further austerity will be required for the government to meet its legal obligations. Further austerity is something that will not be well received by the public.

Consequences of Contagion

The consequences for the Italian government of a loss in investor confidence would be that interest rates on government debt would rise, making a balanced budget even more difficult to achieve. Significantly higher interest rates on Italian government debt, if sustained, would negatively affect Italy's credit rating.

Forward-Looking Indicators (FLI)

By most measures, Italy performs quite well compared to other countries with regard to forward-looking indicators. It performed weaker in only two categories: 1) transparency and accountability; and 2) future resources. The closed nature of the Italian political system is a relevant problem, because despite an often vibrant public debate regarding important issues, in the end decisions are often reached by key players behind closed doors. The concern regarding future resources centers on the need to finance an already large government debt while the country is undergoing a major demographic transition.

Italy performs well in four key areas: 1) crisis management; 2) the rule of law; 3) social cohesion; and 4) policy implementation. Italy's long history of successfully overcoming numerous economic and political crises is a strength. Although the law can often be an encumbrance, the rule of law still represents a bulwark for Italian democracy. And although corruption often occurs at the highest levels of government, fighting corruption remains a major priority. The country scores high in terms of social cohesion because, despite recent immigration of non-Europeans, Italian society remains relatively homogeneous by world standards. This homogeneity facilitates societal cooperation. The country rated strongly regarding policy implementation because, given its history of crises, the bureaucracy has learned to implement policies needed to resolve crises.

Recent Political Developments

The current technocratic government was installed in November 2011 in an effort to deal with Italy's role in the ongoing eurozone crisis. Similar to past technocratic

governments in Italy, the cabinet consists mainly of academics and other experts with various backgrounds, led by Mario Monti, a professor at the prestigious Bocconi University. He is also a former EU commissioner for competition. Having a technocratic government is not new in Italy. In the early 1990s, a similar government rose to power, although that crisis was more severe than the present problem.

This government is supported by a broad-based coalition ranging from center-left to center-right. To date, Prime Minister Monti has generally tried, rather successfully, to depolarize and avoid an escalation of conflicts.

The government's agenda is challenging and includes actions aimed at dealing with a multitude of Italy's accumulated problems, in particular within contentious areas of public-finance and labor-market reform. The current government has kept the channels of communication open with important societal organizations, but it has also shown a strong determination to proceed with policy innovations despite opposition from powerful interest groups that have been more inclined to defend the status quo. The latter was particularly evident with labor-law and professional-association reforms. Labor-law reforms, as expected, triggered strong negative reactions from trade unions. Reforms aimed at the liberalizing professions generated strong opposition from professional associations. Nonetheless, perhaps because of the nature and depth of the ongoing financial crisis, the social climate has remained relatively calm.

A technocratic government is far from ideal in a well-functioning democracy. Since the government's tenure is limited by design, general elections will be held by April 2013. The risk to investors is to what extent the newly elected government will be willing to continue the reform process effectively initiated by Prime Minister Monti. Also, as indicated earlier in this report, since meeting a balanced budget in 2013 and 2014 will likely require further austerity, it will be important to gauge the depth of political support for such austerity in the post-election period. At the same time, in early October, the Monti government, in an attempt to make austerity more palatable to the electorate, proposed a modest income tax cut for low-income earners. Much of the tax cut will be financed by a new financial-transaction tax, unspecified levies on financial institutions, previously announced spending cuts, as well as a 1 percent increase in VAT (reduced from a previously scheduled 2 percent rise).

Since Monti has strong support from the public, many have asked that he stay on beyond next April's election. He has frequently said no. However, he recently indicated that if the election does not produce a strong and effective government, he might be willing to serve if parliament asks him to.

Country Committee Average Scores

MACROECONOMIC INDICATORS	7.3
Economic Fundamentals	**6.8**
Real GDP Growth %	4.8
GDP Per Capita	8.2
Real Exports (% Change)	6.3
Real Imports (% Change)	7.0
Gross Domestic Investment/GDP (%)	7.6
Gross Domestic Savings/GDP (%)	8.8
Inflation-CPI (%)	6.2
Population Growth (% Change)	5.2
Public Sector / Fiscal Policy	**5.8**
General Government Debt/GDP (%)	4.3
Nominal GDP Growth (Local Currency %)	4.2
General Govt Debt/General Govt Revenue (%)	4.5
General Govt Interest/General Govt Revenue (%)	4.9
General Govt Primary Balance/GDP (%)	7.2
General Govt Fiscal Balance/GDP (%)	6.8
General Govt Revenue/GDP (%)	7.4
General Govt Expenditure/GDP (%)	7.0
Monetary Policy	**9.0**
Accommodative Monetary Policy	9.0
Capital Markets and Financial Risks	**7.8**
Domestic Credit/GDP (%)	9.2
Domestic Credit (% Change)	8.1
Overall strength of banking sector	6.2
External Sector	**7.1**
Current Account	7.0
External Debt	7.2

FORWARD LOOKING INDICATORS	7.2
Political Economic and Social Stability	**6.8**
Rule of Law	**7.7**
Legal Certainty	7.6
Independent Judiciary	7.5
Separation of Powers	7.5
Property Rights	8.1
Transparency / Accountability	**5.9**
Corruption Prevention	5.2
Independent Media	5.2
Civil Society Participation	7.4
Social Cohesion	**7.2**
Social Inclusion	6.6
Trust in Institutions	6.9
Societal Meditation	7.8
Conflict Management	7.3
Future Resources	**6.4**
Education	6.8
Research and Innovation	5.2
Employment	6.5
Social Security	6.4
Environmental Sustainability	7.3
Steering Capability and Reform Capacities	**7.5**
Strategic Capacity	**7.0**
Prioritization	7.2
Policy Coordination	7.3
Stakeholder Involvement	6.7
Political Communication	6.8
Implementation	**7.5**
Government Efficiency	7.8
Resource Efficiency	7.2
Adaptability	**7.4**
Policy Learning	7.4
Institutional Learning	7.3
Crisis Management	**8.2**
Historical Evidence of Crisis Management	8.0
Crisis Remediation	7.8
Signaling Process	8.4
Timing and Sequencing	8.4
Precautionary Measures	8.2
Automatic Stabilizers	8.6

ITALY MACROECONOMIC INDICATORS

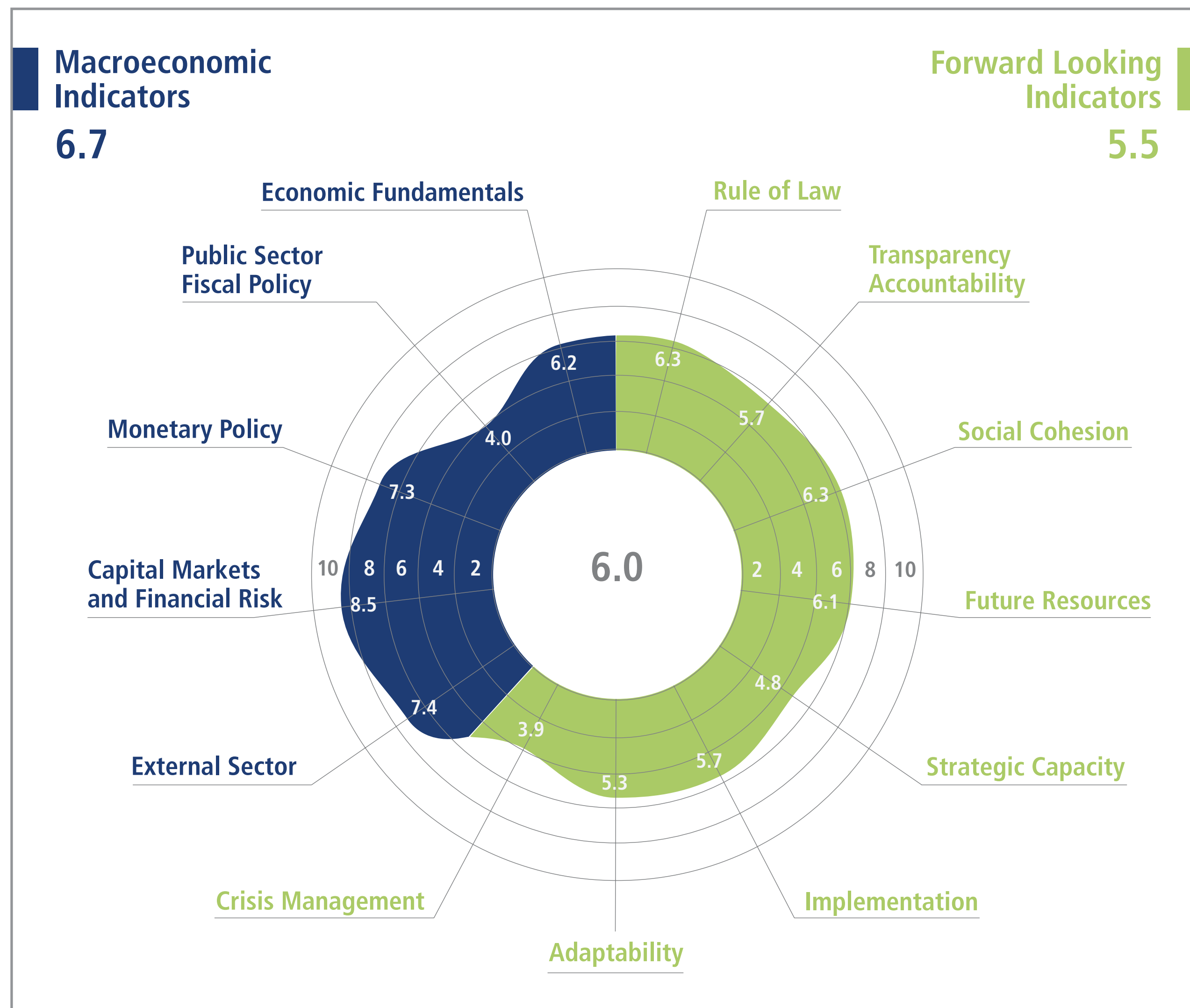
I. Economic Fundamentals	2008	2009	2010	2011	2012f
Nominal GDP Growth (Local Currency %)	1.3	-3. 5	2.2	1.9	-0.8
Real GDP Growth (%)	-1.2	-5.5	1.8	0.4	-1.9
Real Exports (% Change)*	6.3	-26.9	9.4	6.7	-4.0
Real Imports (% Change)	7.2	27.9	17.0	9.5	-6.9
Nominal GDP (bn US$)	2,307	2,111	2,044	2,062	2,102
GDP per capita (US$)	38,559	35,072	33,796	33,925	34,442
GDP per capita (PPP basis: US$)	31,372	29,900	30,500	30,900	31,000
Inflation-CPI (%)	3.5	0.8	1.6	2.9	3.0
Inflation-CPI (%)	3.5	0.8	1.6	2.9	3.0
Population Growth (% Change)	0.77	0.60	0.48	0.48	0.48
Gross Domestic Investment/GDP (%)	21.6	18.8	20.2	20.5	20.5
Gross Domestic Savings/GDP (%)	20.8	18.3	18.3	17.8	18.1
*Exports/Imports include goods only					
II. Public Sector Policy**	**2008**	**2009**	**2010**	**2011**	**2012f**
General Government (GG) Debt/GDP (%)	105.8	116.1	118.7	120.1	125.8
GG Revenue/GDP (%)	46.5	47.1	46.6	46.6	48.9
GG Expenditure/GDP (%)	49.2	52.5	51.2	50.5	51.5
GG Financial Balance/GDP (%)	-2.7	-5.4	-4.6	-3.9	-2.6
Primary Balance/GDP	2.5	-0.8	0.0	1.0	3.0
GG Debt/GG Revenue (%)	227.2	246.9	254.7	257.7	257.2
GG Interest/GG Revenue (%)	11.0	9.8	9.7	10.5	11.5
**The data for this section is from the 2012 AMF Article IV					

III. Capital Markets & Financial Risk	2008	2009	2010	2011	2012f
Domestic Credit (% Change)	6.1	6.6	-0.1	-0.1	5.8
Domestic Credit/GDP (%)	104.8	111.0	122.2	122.3	123.0
IV. External Sector	**2008**	**2009**	**2010**	**2011**	**2012f**
Current Account Balance/GDP (%)	-2.9	-2.1	-3.6	-3.1	-2.2
Data sources: bank of Italy Annual Reports; IMF's Article IV 2012; OECD Annual Reports.					

f = forecast

JAPAN

RATING: 6.0 (A-)



Pros:

- The third largest economy in the world
- High per capita income
- Traditionally high savings rate
- Dynamic export sector
- Stable political institutions
- Large net creditor

Cons:

- World's highest government debt/gross domestic product (GDP) ratio
- World's highest government debt/revenue ratio
- World's second-largest public sector debt
- Ongoing massive refinancing needs
- Poor growth for 20-plus years
- Persistent deflationary pressures for 20-plus years
- Declining population beginning in 2008, plus rapid aging

Summary

For decades, the Japanese economy was the world's second largest. Only recently, it was surpassed by China, a country with over ten times its population. In the 1980s, the country experienced a major asset-price bubble in real estate and the stock market. That bubble burst in 1990-91, resulting in a steep asset-price decline. The Japanese economy has never fully recovered the dynamism it displayed before the crash. During the 10 years from 2002-2011, real GDP annually grew on average by 0.7 percent. During the same time period, nominal GDP actually declined by an annual average of 0.7 percent.

The size and nature of the Japanese bubble were remarkable. At its height, the most expensive commercial real estate in Tokyo was selling for an astronomical US$20,000/sq. ft. More than a decade later, similar properties were worth about 1 percent of their peak. In general, real estate prices fell about 80 percent from their highs.

The Nikkei 225, one of Japan's most important stock indices, peaked at around 40,000 in 1989. By 1992, it had fallen to about 15,000. In 2001, it actually fell further, declining to under 12,000. At its peak, Japan's stock market accounted for over 40 percent of world stock market capitalization, having risen from 15 percent in 1980. Today, the Nikkei 225 stands at about 9,000, less than one-fourth its peak more than two decades ago.

From 1979 to 1991, Japanese consumer debt rose by over 700 percent. By 1991, per capita consumer debt in Japan actually surpassed US per capita consumer debt, despite not having a consumer debt tradition.

Needless to say, once asset prices collapsed, the financial system was under enormous stress. The system required a massive bailout by the government and years of accounting forbearance to keep banks lending to companies that otherwise would have gone bankrupt, so-called zombie banks lending to zombie companies.

As a result of the unprecedented price collapse, the government undertook traditional stimulus programs in an attempt to counteract the deflationary pressures building throughout the economy. The government implemented at least 10 stimulus programs during the 1990s. This caused government debt to soar. By 1998, the government debt/GDP ratio surged above 100 percent, reaching 117.9 percent, a full 20 percentage points higher than in 1997. Since that time, Japanese government debt has climbed steadily, reaching 229.8 percent of GDP by March 2012, by far the highest in the world. Since the Japanese government sector is relatively small as a percentage of GDP compared to most other advanced industrial countries, the debt/revenue ratio shows the government is in a far worse position than the debt/GDP ratio would imply. In March 2012, the debt/revenue ratio was 750.7 percent. To put that into perspective, the debt/revenue ratio for Italy, usually considered among the most heavily indebted advanced industrial countries, was only 260.5 percent at year-end 2011, or about one-third Japan's level.

One reason that Japan's heavy debt load has not caused a government financial crisis is the fact that the debt has been easy to finance domestically. The country, until recently, has regularly run current account surpluses. Japan is the world's largest net creditor. Without these special attributes, it is doubtful that Japan would be capable of carrying such a large government debt burden. Nonetheless, over time, as the country's population continues to decline and age rapidly, and as the debt continues to build, there is likely to be a time when financing the huge debt load will prove challenging. The risks facing the government appear to well justify a rating of A-.

The Economy

The March 11, 2011 earthquake and tsunami (generally known in Japan as the Great East Japan Earthquake) exposed serious weaknesses in Japan's regulatory environment, especially regarding nuclear power. At the same time, reconstruction following the natural disaster demonstrated the economy's ability to adapt quickly to changing circumstances.

Growth accelerated in 1Q12, underpinned by reconstruction spending and a pickup in consumer demand, much of it related to inventory restocking and government subsidies for environmentally friendly automobiles. However, growth decelerated in 2Q12. Most observers expect flat growth for 3Q12 and 4Q12. The economic slowdown appears to be related to three developments: 1) waning earthquake reconstruction spending; 2) a sharply higher yen; and 3) slowing world demand for Japanese exports.

More Stimulus Needed

The government of Prime Minister Yoshihiko Noda has recently proposed further fiscal stimulus to boost growth. These requests are being stalled because of a major political dispute in the Japanese Diet, the country's parliament. In August, Prime Minister Noda made a deal with opposition lawmakers that if they went along with a doubling of Japan's 5 percent sales tax (discussed below), he would soon call a new election. The dispute is over the timing of the election.

The prime minister appears reluctant to call new elections because the popularity of his party has declined significantly since he took the office in 2011. However, the Liberal Democratic Party (LDP) and the

New Komeito Party are demanding that elections be called quickly. These parties have vowed to prevent new stimulus legislation from passing before a new election is announced. The prime minister isn't legally required to call elections before August 2013. As of the writing of this report, the issue remains unresolved. However, even if stimulus is passed, such stimulus will not likely change Japan's growth trajectory significantly.

Labor Market Conditions

Despite two decades of weak growth, unemployment is not a major problem for Japan. For instance, since 2001 the rate of unemployment has remained between 3.9 percent and 5.4 percent, an enviable rate compared to most other advanced industrial nations. Given the country's population and labor force dynamics, however, this should not be surprising. The labor force has already started a long-term secular decline. Over time, labor shortages will become prevalent.

Deflation

Deflation, not inflation, remains Japan's major pricing problem. It appears that the Bank of Japan's target inflation rate of 1 percent will not be reached this year. Core inflation has not been above 1 percent for one year since 1993. Recently, there have been calls for an even looser monetary policy to counteract weak growth and to avoid another round of declining prices.

Interest Rates

Short-term interest rates are already at or near zero. Quantitative easing seems the only other monetary-stimulus tool available. Some analysts are calling for more foreign-exchange intervention, which would boost the monetary base and possibly stimulate more M2 and M3 growth. In addition, if the yen can be driven down against the US dollar and the euro on a sustained basis, this might help reduce some of Japan's deflationary pressures by raising import prices. The Bank of Japan recently announced additional quantitative easing.

The Japanese Financial System

Japan's financial system is relatively strong as measured by standard statistics, with the non-performing loans (NPLs) to total loans ratio declining to about 3 percent at the end of 2011 from a peak of 9 percent in 2003. The improvement resulted from several years of restructuring and private-sector deleveraging. The main risk to the strength of the banking sector comes from the banks' significant holdings of government securities (80 percent of GDP at year-end 2011, up from 40 percent at year-end 2007). Any significant rise in government-bond yields could undermine the strength of the sector through its impact on market-to-market valuations. The government, however, could deal with such changes in the near term, through accounting forbearance. Nonetheless, it remains a risk.

The External Sector

On the external side, exports declined sharply in 2011 due to the earthquake, Thai floods, weak global demand and an appreciation of the yen. Imports, on the other hand, increased as a result of reconstruction spending and higher energy costs. Consequently, in 2011 Japan recorded its first annual trade deficit (1 percent of GDP) since 1981.

The country's current account has regularly been in surplus. However, the building blocks of that surplus have been steadily shifting. In recent years, net investment income from abroad has come to play an increasingly important role in counteracting a weaker net export position. For instance, in 2008, net investment accounted for 96.8 percent of the current account surplus. In 2009 and 2010, it accounted for 93 percent and 69.4 percent of current account surpluses, respectively. Given 2011's trade deficit, net investment income accounted for 147 percent of the current account surplus. Without such a substantial net income balance, the country would have recorded a deficit.

Net investment income is a significant strength for the country. At the same time, its growing importance represents a secular decline in the ability of the Japanese government to finance itself. As the population falls and ages rapidly, the country's competitiveness is likely to decline. At some point, current account deficits are likely to emerge on a regular basis. When that happens, the government will find that it needs to call upon foreign savings to fund itself. Government finances may then be under stress.

At present, Japan is the world's largest net external creditor, with a net foreign asset position of ¥253 trillion in 2011. Net foreign assets were over 50 percent of GDP at year-end 2011, with the government, financial, corporate and household sectors all being external creditors. The country's current gold and foreign exchange reserves amount to more than US$1.2 trillion.

Sales Tax Rise

As noted earlier, Japan's general government debt, in absolute terms and relative to GDP and revenue, is extremely high. In FY 2011 (ending March 2012), gross debt stood at 230 percent of GDP. The debt/revenue ratio stood at 750.7 percent of revenue. Given that Japanese general government revenue represents only about 30 percent of GDP, increases in revenue required to help lower the deficit involve large percentage increases in taxes. For example, in August 2012, the Japanese Diet passed a law doubling the sales tax (Japan's equivalent of VAT or GST) from 5 percent to 10 percent. The increase will be implemented in two stages. First, it will rise to 8 percent in April 2014. It will then rise to 10 percent in October 2015. There is considerable concern among consumers that this tax increase will derail the economy, much as a similar tax increase did in 1997. Nonetheless, despite the size of the tax increase, there was overwhelming across-the-board support for it by Japan's major political parties. There is a recognition that something must be done to contain Japan's ever-increasing debt mountain. However, even this sharp rise in the country's sales tax will go only part of the way towards slowing the rise in government debt.

Low Financing Costs

Since the economy continues to suffer from deflationary pressures, and since revenue is generally tied to nominal prices, the task of revenue generation is more complicated for Japan than for other countries. However, deflationary pressures and the weak economy have combined to allow for an extended period of extremely low interest rates. This has benefitted the government because the cost of financing its debt has been remarkably low.

Japanese government debt is about 100 percentage points of GDP higher than Italy's. In addition, although Italy's revenue/GDP ratio is 51 percent higher than Japan's, in 2011 the Japanese government still had only an interest/revenue ratio of 9.5 percent, compared to 10.4 percent for Italy.

Primary Deficits

Unlike Italy, Japan has usually run primary deficits, although during the early years of the last decade, the government had been steadily reducing its primary deficits. In fact, in 2007 the government actually reported its first primary surplus in many years. However, the global financial crisis and its aftermath turned the primary balance again to deficit. In 2008, the primary deficit was a modest 1.6 percent, but it has climbed significantly since 2009. In 2011, the primary deficit was 7.2 percent of GDP, the second highest primary deficit among advanced industrial countries.

Financial Deficits

With ongoing primary deficits, the government's financial deficit was obviously higher. After falling to 2.1 percent in 2007, the financial deficit rose to 4.1 percent in 2008, 10.4 percent in 2009, 9.4 percent in 2010, and 10.1 percent in 2011. It is clear to the government and to opposition parties that such deficits are unsustainable, helping to explain the multi-party support for a doubling of the sales tax.

Forward-Looking Indicators (FLI)

Compared to other advanced industrial countries, Japan performs relatively poorly when looking at FLI. It was judged particularly weak in three areas: 1) crisis management; 2) transparency and accountability; and 3) strategic capacity.

Crisis Management

In general, the Japanese government appears to require considerable time to debate any course of action before reaching a broad consensus. Once a decision is made, however, the government can usually implement it relatively efficiently. However, delays caused by the byzantine decision-making process make crisis management difficult. For instance, according to Naoto Kan, the prime minister during the Fukushima crisis, the nuclear emergency-preparedness law, set up in 1999, was totally inadequate because the potential cases outlined in the law did not extend to what happened in Fukushima. The result: no flexible and well-working line of command could be put in place, causing a seriously deficient response to the crisis.

Another crisis where the government may have been considered slow to act relates to the collapse of the bubble economy. Fiscal- and monetary-policy tools were used too little, too late, making the downturn worse than necessary. Again, the government found it difficult to reach a consensus on consistent policies.

The government's handling of the East Asian crisis is another example of indecisiveness in dealing with a crisis.

Transparency and Accountability

Japan scored relatively low on transparency and accountability. Corruption and bribery scandals have been major factors in Japanese politics for decades. These problems are deeply entrenched, exacerbated by the way Japanese politicians need to raise campaign contributions, how they rely on local support networks, and how they have to "deliver" to their constituencies in return. Scandals have plagued both the long-reigning LDP and the Democratic Party of Japan (DPJ). Even the DPJ, which in 2009 campaigned on greater transparency, slowly reduced transparency as numerous scandals emerged.

Although the media are legally free in Japan, informal self-censorship seems to prevail, resulting in reduced transparency and accountability. In an attempt to maintain access, reporters are often reluctant to antagonize politicians or powerful corporate leaders. For instance, the media did not ask tough questions of the government or TEPCO, the major electric power company, even while radiation was leaking from major TEPCO facilities.

Strategic Capacity

Japan also scores relatively low is in strategic capacity. Since 1945, policy-making has been traditionally dominated by the tight relationship between the government and the Liberal Democratic Party, the party in power for most of the last 60-plus years. Ministers have been torn between what their party or their party factions expected from

them, and what well-informed career bureaucrats within the ministries wanted them to do. A similar problem exists today even while the DJP leads the government.

Japan seems to have a unique problem regarding policy coordination. Inter-ministerial competition for resources and power can be so large that formal mechanisms have had to be put in place to promote intra-governmental cooperation. For instance, in June, the cabinet adopted a new basic policy that stated: "Each cabinet minister will work in close cooperation with his or her cabinet colleagues without seeking to further the interests of only one ministry, and will make concerted efforts under the leadership of Prime Minister Noda." The need to state what should be obvious is indicative of the depth of policy coordination problems.

Japan scored more strongly in three areas: 1) rule of law; 2) social cohesion; and 3) future resources.

Rule of Law

Although rule of law was considered one of the country's strengths, it still registered lower than for other advanced nations. While property rights are protected, the judicial system is considered more pliant towards the government and its administrative apparatus than in most other advanced countries.

For important cultural reasons, rule of law is viewed quite differently from the Western tradition. In the end, laws are supposed to serve the common good and are not meant as immovable norms to which courts blindly adhere. Yet, although most Japanese expect a wide and cumbersome set of explicit bureaucratic rules to govern daily life, administrative officials often have enough leeway to produce idiosyncratic results since many decisions require administrative interpretation.

Social Cohesion

Japan also scored relatively well on social cohesion. One of the most important factors is the relative homogeneity of its population. Minorities make up a small percentage of the population yet still face significant discrimination. They include an estimated three million Burakumin, outcasts of the feudal period, about 600,000 ethnic Koreans, and a smaller minority of ethnic Chinese, Brazilians and Filipinos.

Once a model for income and wealth equality, Japan developed considerable problems of income inequality and poverty during the last decade. According to a 2008 OECD study, Japan´s rate of poverty worsened considerably from 2000, giving it the fourth-highest share among OECD countries of people earning less than half of median income.

Future Resources

Japan also scored better on future resources, in part due to its highly educated workforce. Although its educational system is sometimes criticized for being heavily oriented towards rote learning, the country scores well on most international education scorecards. Japan is one of the world's leading technological powers, ranking high in terms of research and innovation. Unemployment is not generally considered a major problem. If anything, as noted above, the country will likely experience a growing labor shortage.

The Japanese social safety net is well developed, although it lags those of other advanced industrial countries in terms of the percentage of GDP devoted to it. Given the government's financial position, and a rapidly aging population, there is a general recognition that major changes to the social safety net are needed.

Recent Political Developments

As noted above, the present government's popularity is low. As of the writing of this report, the government had not yet announced a date for new elections. Since the opposition voted in August in favor of new economic stimulus measures advocated by the government on the premise that new elections would soon be called, the opposition is now refusing to support those measures until that happens. The Japanese economy needs the stimulus measures.

Most observers expect that new elections will result in a return to power of the LDP. However, such a change in government will not significantly change economic policy. Any future government will face the same daunting tasks that exist today, including the need to increase economic growth, spur a modest rate of inflation, and reduce the size of the primary and financial deficits.

Country Committee Average Scores

MACROECONOMIC INDICATORS	6.66
Economic Fundamentals	**6.17**
Real GDP Growth %	4.33
GDP Per Capita	8.50
Real Exports (% Change)	7.83
Real Imports (% Change)	5.33
Gross Domestic Investment/GDP (%)	7.67
Gross Domestic Savings/ GDP (%)	8.00
Inflation-CPI (%)	4.50
Population Growth (% Change)	3.17
Public Sector / Fiscal Policy	**3.97**
General Government Debt/GDP (%)	2.58
Nominal GDP Growth (Local Currency %)	2.83
General Government Debt/General Government Revenue (%)	3.25
General Government Interest/General Government Revenue (%)	4.92
General Government Primary Balance/GDP (%)	3.67
General Government Fiscal Balance/GDP (%)	3.83
General Government Revenue/GDP (%)	5.17
General Government Expenditure/GDP (%)	5.50
Monetary Policy	**7.33**
Accommodative Monetary Policy	7.33
Capital Markets and Financial Risks	**8.47**
Domestic Credit/GDP (%)	9.17
Domestic Credit (% Change)	8.40
Overall strength of banking sector	7.83
External Sector	**7.36**
Current Account	8.92
External Debt	5.80

FORWARD LOOKING INDICATORS	5.51
Political Economic and Social Stability	**6.11**
Rule of Law	**6.33**
Legal Certainty	6.17
Independent Judiciary	6.50
Separation of Powers	5.83
Property Rights	6.83
Transparency / Accountability	**5.70**
Corruption Prevention	5.67
Independent Media	5.83
Civil Society Participation	5.60
Social Cohesion	**6.29**
Social Inclusion	6.33
Trust in Institutions	5.83
Societal Meditation	6.17
Conflict Management	6.83
Future Resources	**6.13**
Education	6.50
Research and Innovation	6.50
Employment	6.67
Social Security	5.33
Environmental Sustainability	5.67
Steering Capability and Reform Capacities	**4.90**
Strategic Capacity	**4.75**
Prioritization	4.33
Policy Coordination	5.00
Stakeholder Involvement	5.00
Political Communication	4.67

Implementation	5.67
Government Efficiency	5.17
Resource Efficiency	6.17
Adaptability	**5.33**
Policy Learning	5.67
Institutional Learning	5.00

Crisis Management	3.86
Historical Evidence of Crisis Management	4.00
Crisis Remediation	3.67
Signaling Process	3.67
Timing and Sequencing	4.00
Precautionary Measures	4.17
Automatic Stabilizers	3.67

JAPAN MACROECONOMIC INDICATORS

I. Economic Fundamentals	2008	2009	2010	2011	2012f
Nominal GDP Growth (Local Currency %)	-2.3	-6.0	2.3	-2.8	1.5
Real GDP Growth (%)	-1.0	-5.5	4.4	-0.7	2.4
Real Exports (% Change)	1.4	-24.2	24.2	-0.1	3.1
Real Imports (% Change)	0.3	-15.7	11.1	5.9	7.4
Nominal GDP (bn US$)	4,849	5,035	5,488	5,869	5,981
GDP per capita (US$)	37,976	39,476	43,015	45,920	46,973
GDP per capita (PPP basis: US$)	34,014	32,509	34,330	34,739	36,040
Inflation-CPI (%)	1.4	-1.3	-0.7	-0.3	0.2
Population Growth (% Change)	-0.05	-0.11	0.03	0.18	-0.38
Gross Domestic Investment/GDP (%)	23.0	19.7	19.8	19.9	20.7
Gross Domestic Savings/GDP (%)	26.1	22.4	23.3	21.9	23.0

II. Public Sector Policy	2008	2009	2010	2011	2012f
General Government (GG) Revenue/GDP (%)	31.6	29.6	29.6	30.6	31.1
GG Expenditure/GDP	35.7	40.0	39.0	40.7	41.1
GG Primary Balance/GDP (%)	-3.8	-9.9	-8.7	-9.2	-8.8
GG Financial Balance/GDP (%)	-4.1	-10.4	-9.4	-10.1	-10.0
GG Debt/GDP (%)	191.8	210.2	215.3	229.8	235.8
GG Debt/GG Revenue (%)	607.0	710.1	727.4	751.0	758.2
GG Interest/GG Revenue (%)	6.3	6.7	6.7	7.2	7.1
III. Capital Markets & Financial Risk	**2008**	**2009**	**2010**	**2011**	**2012f**
Domestic Credit (% Change)	1.6	0.4	1.3	0.8	2.4
Domestic Credit/GDP (%)	302.4	329.8	329.0	340.9	123.0
V. External Sector	**2008**	**2009**	**2010**	**2011**	**2012f**
Current Account Balance/GDP (%)	3.2	2.8	3.6	2.0	2.2

Data sources: OECD Economic Outlook, World Bank, IMF Japan 2012 Article IV Consultation; IMF World Economic Outlook 2012; OECD Economic Outlook Annex; IFS Yearbook 2012; Bank of Japan.

f = forecast

CONCLUSION

The overall objective of this report

This sample rating report is the logical next step for INCRA to demonstrate that it is possible to change the current system of sovereign ratings. Our sample ratings prove that:

- Transparency – meaning providing all the data, background information and average scores from committee voting – should be defined as a basic principle for sovereign risk assessment.
- A broader understandability of sovereign ratings can be achieved by introducing new forms of presentation, such as our "rating radar".
- Quantitative and qualitative indicators should serve as a comprehensive set for every sovereign risk analysis.

In essence, we believe it's time to change the narrative of how sovereign ratings are perceived and discussed. Instead of viewing them as a national insult in case of a downgrade or an unpredictable and not serious assessment of countries, they should be seen as a solid blueprint to start an in-depth debate about a country's needed reforms.

Furthermore, sovereign ratings should be defined as public goods and therefore it should be the responsibility of all the major players of society to support the improvement of this sector of the financial world.

The first INCRA report and this report have demonstrated that there is an alternate way to address the highly important and sensitive issue of how sovereign ratings are conducted. INCRA is an innovative solution that merges the changing demands and interests of investors assessing sovereign risk and the desire of governments and the broader public for more transparency, legitimacy and accountability.

As the sample ratings of this report prove, to evaluate a country's willingness to repay its debts, a more comprehensive set of indicators is needed. That is why INCRA would conduct its sovereign risk assessments using a set of macroeconomic indicators and FLI that will provide the basis for high-quality analysis, as shown in this report. These FLI capture a meaningful picture of a country's long-term socioeconomic and political prospects and the potential political and social constraints on its ability and willingness to pay. Therefore, INCRA would also be an incubator for best practices in sovereign-risk analysis.

The financial realities of the 21st century have already outpaced the trans-Atlantic partners and their desire to work things out, together or on their own. INCRA reflects these new realities of the globalized financial world, where the quality of sovereign ratings is crucial not only for Europe and the US but also for emerging economies such as China and Brazil. The hunger for borrowing money will increase in the emerging economies, giving them a strong self-interest in a reliable framework to analyze their sovereign risk. Therefore, INCRA would guarantee the participation of all the relevant international players – it would be the first truly international CRA.

But to create a more coherent international system for CRAs, whether they are for-profit or non-profit, a broader dialogue must be facilitated on how to overcome the irresponsible fragmentation of regulatory requirements around the world. That is why a broadly accepted and implemented international regulatory framework must be developed to oversee and govern the sector.

Of course, there are more challenges ahead to bring INCRA to life.

1) Investors may need to change their organizational behavior. In spite of their partial frustrations with the current system, most investors continue to rely on information from the big three CRAs, whose ratings are often embedded in internal investment guidelines. INCRA will be seen as the "new kid on the block" of the CRA world. Its model needs to be robust enough to convince investors that it will provide added value for their investment decisions.

2) Governments must take a stand. They must turn from simply criticizing how sovereign ratings are conducted to reforming the system in a way that is convincing and sustainable.

3) Representatives of the non-profit sector, whether NGOs or foundations, need to be encouraged to play a meaningful role in the financial world.

Overall, we still believe that there are major improvements that need to be achieved in the CRA world. Therefore we still advocate that the G20, the group of the most important economic and financial players in today's world, is the best forum to evaluate the political will for founding a new institution that will be embedded in the markets but also in society. Additionally corporate players, NGOs and foundations need to come on board with their commitment to improve the sovereign risk sector.

Changing the current system requires bold and big thinking. INCRA is a big idea based on a reasonable operational concept. It would come with an endowment of US$400 million. At first glance this is a lot of money, but in reality it becomes a small, manageable investment if divided among multiple funders. In comparison to the hundreds of billions of dollars already paid for public bailouts – partially the result of flawed corporate and sovereign risk analysis – it is a modest and safe call.

INCRA has the potential to become a cornerstone of a financial system capable of dealing with 21st century problems. As the sample ratings found in this report demonstrate, not only do we need different institutions to assess sovereign risk, but we also need a more coherent and transparent methodology to analyse that risk. What is required now is the political will and support of visionary leaders around the world.

INCRA RATINGS SCALE

8.00 - 10.00	AAA
7.70 - 7.99	AA+
7.30 - 7.69	AA
7.00 - 7.29	AA-
6.70 - 6.99	A+
6.30 - 6.69	A
6.00 - 6.29	A-
5.00 - 5.99	BBB+
4.00 - 4.99	BBB
3.00 - 3.99	BBB-
2.00 - 2.99	Below investment grade
1.00 - 1.99	

MACROECONOMIC INDICATORS CODEBOOK

I. Economic Fundamentals

Real GDP Growth (%)

Is real GDP growth adequate to raise real income over time and sufficient to satisfy domestic political needs?

1	2	3	4	5	6	7	8	9	10
Totally inadequate									Substantially exceeds needs

GDP per capita (current exchange rates in US$) and GDP per capita (PPP basis: US$)

What is the level of wealth and development of a country? GDP per capita (PPP basis) is within which percentile, and what is expected to happen over time?

1	2	3	4	5	6	7	8	9	10
Lowest			Lower Middle Income Countries	Upper Middle Income Countries			High Income Countries		Highest

Real Exports (% Change)

What is the importance of exports in this country's performance?

1	2	3	4	5	6	7	8	9	10
Export sector performing poorly									Export sector performing well or exports not important to country's performance

Real Imports (% Change)

To what extent is the country's performance affected by its import needs?

1	2	3	4	5	6	7	8	9	10
Import needs are high/import needs are affecting the country's performance									Import needs are low/import needs are not affecting the country's performance

Gross Domestic Investment/GDP (%)
Is a country's investment ratio sufficient to address its development needs and support infrastructure at a level that will not hinder growth?

1	2	3	4	5	6	7	8	9	10
Investment ratio insufficient									Investment ratio sufficient

How does a country's investment ratio compare now and is expected to compare in the future to the median of its income peers?

1	2	3	4	5	6	7	8	9	10
Investment ratio is significantly below peer median (current or expected)									Investment ratio is at peer median (current or expected)

Gross Domestic Savings/GDP (%)
To what extent is a country's savings ratio sufficient to support necessary investment without causing balance of payments problems?

1	2	3	4	5	6	7	8	9	10
Savings ratio insufficient									Savings ratio sufficient

How does a country's savings ratio compare now and in the future to the median of its income peers?

1	2	3	4	5	6	7	8	9	10
Savings ratio is significantly below peer median (current or expected)									Savings ratio is at peer median (current or expected)

Inflation/CPI (%)
Are price changes distorting economic decision making, either through excessive inflation or deflation, and how will price changes affect future economic performance?

1	2	3	4	5	6	7	8	9	10
Price changes already or are likely to cause major problems for the economy (e.g. hyperinflation or pernicious deflation)									Price changes are not creating, nor likely to create a distortion

Population Growth (% Change)
Is a country's demographic trajectory beneficial or burdensome to long-term economic performance and sustainability of the social security system?

1	2	3	4	5	6	7	8	9	10
Highly burdensome									Highly beneficial

II. Public Sector Policy

General Government Debt/GDP (%)
To what extent does a country's debt/GDP ratio constrain its economic progress?

1	2	3	4	5	6	7	8	9	10
Debt/GDP ratio significantly constrains economic progress									Debt/GDP ratio does not constrain economic progress

How does a country's debt/GDP ratio compare to its income peers today and in the future?

1	2	3	4	5	6	7	8	9	10
Debt/GDP ratio is significantly higher than peer median (current or expected)									Debt/GDP ratio is at or below peer median (current or expected)

Nominal GDP Growth (Local Currency %)
Is expected nominal GDP growth adequate to meet government financing over time?

1	2	3	4	5	6	7	8	9	10
Totally inadequate									Substantially exceeds needs

General Government Debt/General Government Revenue (%)
To what extent does a country's debt/ revenue ratio put pressure on revenue generation and constrain the government's spending flexibility?

1	2	3	4	5	6	7	8	9	10
Debt/revenue ratio significant constraint									Debt/revenue ratio not a constraint

How does a country's debt/GDP ratio compare to its income peers today and in the future?

1	2	3	4	5	6	7	8	9	10
Debt/revenue ratio is significantly higher than peer median (current or expected)									Debt/revenue ratio is at or below peer median (current or expected)

General Government Interest/General Government Revenue (%)
To what extent does a country's debt service costs put pressure on revenue and spending flexibility?

1	2	3	4	5	6	7	8	9	10
GG interest/ revenue ratio is a significant constraint									GG interest/ revenue ratio is not a significant constraint

How does a country's GG interest/revenue ratio compare to its income peers today and in the future?

1	2	3	4	5	6	7	8	9	10
GG interest/ revenue ratio is significantly higher than peer median (current or expected)									GG interest/ revenue ratio is at or below peer median (current or expected)

General Government Primary Balance/GDP (%)
How large is the primary deficit or surplus, and what is expected in the future?

1	2	3	4	5	6	7	8	9	10
Country has significant primary deficit (current or expected)									Country has significant primary surplus (current or expected)

General Government Revenue/GDP (%)
How broad-based is the tax system and what is the rates' level? Can the latter be adjusted easily? How flexible is the revenue structure?

1	2	3	4	5	6	7	8	9	10
Narrow, inflexible tax system and inflexible revenue structure									Broad-based, flexible tax system and revenue structure

General Government Expenditure/GDP (%)
How effective are expenditure programs and infrastructure? To what extent does the pension system affect expenditure flexibility?

1	2	3	4	5	6	7	8	9	10
Ineffective expenditure programs; pension system reduces expenditure flexibility									Effective expenditure programs in place; pension system allows expenditure flexibility

III. Monetary Policy

Is monetary policy accommodative?

1	2	3	4	5	6	7	8	9	10
Not accommodative									Very accommodative

IV. Capital Markets and Financial Risk

Domestic Credit/GDP (%)

Is the domestic credit/GDP ratio consistent with the country's economic progress, and is it likely to be so in the future? (If possible, countries should be compared to peers: High-income countries automatically receive a 10. Middle or low-income countries need to be compared to their peers.)

1	2	3	4	5	6	7	8	9	10
Domestic credit/GDP ratio far higher or lower than peers (current or expected)									Domestic credit/GDP ratio similar to peers (current)

Domestic Credit (% Change)

Is domestic credit growth a potential source of credit risk now or in the future? (If future trends are expected to be different, then adjustments need to be made in the final score.)

1	2	3	4	5	6	7	8	9	10
Credit growth is far in excess of nominal GDP growth									Credit growth is near or below nominal GDP growth

What is the overall strength of the banking sector?

1	2	3	4	5	6	7	8	9	10
Banking sector is weak; non-performing loans account for more than 10% of total loans for the system									Banking sector is strong; Non-performing loans comprise no more than 2% of total loans for the system

V. External Sector

How does an emerging market (EM) country's current account position affect its development today and in the future?

1	2	3	4	5	6	7	8	9	10
Any deficit in excess of 10% of GDP today or expected in the future									Any country, which has maintained, and appears likely to continue to maintain a current account surplus in excess of 5% of GDP

How does an EM country's current account position compare to its peers today and in the future?

1	2	3	4	5	6	7	8	9	10
Any deficit in excess of 10% of GDP today or expected in the future									Any country, which has maintained, and appears likely to continue to maintain a current account surplus in excess of 5% of GDP

External Debt (US$)*, External Debt/GDP (%)* and External Debt/Exports ratio (%)*

How does an EM country's external indebtedness constrain its developmental progress?

1	2	3	4	5	6	7	8	9	10
Debt service costs greatly constrain developmental progress									Debt service costs do not greatly constrain developmental progress

How does an EM country's debt service ratio compare to its income peers today and in the future?

1	2	3	4	5	6	7	8	9	10
Debt service ratio is significantly higher than peer median (current or expected)									Debt service ratio ratio is at or below peer median (current or expected)

Coverage by Reserves

External Debt/International Reserves (%)* [Foreign Exchange Reserves (US$)* is the same thing as International Reserves]

How significant is an EM country's debt/reserves cover to avoid financial risk? (What does this imply about the possibility of a debt crisis?)

1	2	3	4	5	6	7	8	9	10
Country's debt/ reserves ratio is in excess of 100% and is far in excess of its peer median (current or expected)									Country's debt/ reserves ratio is equal to 100% (current or expected)

M2/Foreign Exchange Reserves*

Does the ratio of M2/FX reserves pose a risk today or in the future of capital flight in an EM country?

1	2	3	4	5	6	7	8	9	10
Expected M2/FX reserves ratio in excess of 6									Expected M2/FX reserves ratio is 1

Reserves to Imports (months)*

How many months of imports of goods and services does an EM country's international reserve cover today and in the future?

1	2	3	4	5	6	7	8	9	10
Less than 1 month today or in the future									One year's cover today or in the future

Composition of Debt Servicing

Debt Service Ratio (%)*

Is an EM country's debt service ratio manageable today and in the future?

1	2	3	4	5	6	7	8	9	10
Debt service ratio at or above 100% (current or expected)									Debt service ratio less than 15% (current or expected)

Short-Term External Debt/Total External Debt (%)*

How pressing is an EM country's short-term external debt on the ability of an EM country to have market access today and in the future?

1	2	3	4	5	6	7	8	9	10
Short-term/ external debt ratio is near 100%									Short-term/ external debt ratio is less than 20% (current or expected)

External Short-Term Debt + Current Maturities Due on Medium-to-Long External Debt/FX Reserves (%)*

How well positioned is an EM country to sustain a loss of market access?

1	2	3	4	5	6	7	8	9	10
Ratio significantly in excess of EM peers									Ratio of less than 100% (current or expected)

Liquidity Ratio

Total Liabilities Owed to Bank for International Settlements Banks/Total Assets Held in BIS Bank (%)*

1	2	3	4	5	6	7	8	9	10
Ratio far in excess of 1.00									Ratio of close to zero

CODEBOOK
FORWARD-LOOKING INDICATORS

I. POLITICAL, ECONOMIC AND SOCIAL STABILITY – FACTORS FOR FUTURE GROWTH AND FINANCIAL RELIABILITY

Political and Institutional Stability

1. Rule of Law

To what extent do government and administration act on the basis of and in accordance with legal provisions or culturally accepted norms to provide legal or practical certainty?

This question assesses the extent to which executive actions are predictable (i.e., can be expected to be guided by law).

Score	Description
10	Government and administration act predictably, on the basis of and in accordance with legal provisions. Legal regulations are consistent and transparent, ensuring legal certainty.
7	Government and administration rarely make unpredictable decisions. Legal regulations are consistent, but leave a large scope of discretion to the government or administration.
4	Government and administration sometimes make unpredictable decisions that go beyond given legal bases or do not conform to existing legal regulations. Some legal regulations are inconsistent and contradictory.
1	Government and administration often make unpredictable decisions that lack a legal basis or ignore existing legal regulations. Legal regulations are inconsistent, full of loopholes and contradict each other.

To what extent do independent courts control whether government and administration act in conformity with the law?

This question examines how well the courts can review actions taken and norms adopted by the executive branch. To provide effective control, courts need to pursue their own reasoning free from the influence of incumbent governments, powerful groups, or individuals. This requires a differentiated organization of the legal system, including legal education, jurisprudence, regulated appointment of the judiciary, rational proceedings, professionalism, channels of appeal, and court administration.

Score	Description
10	Independent courts effectively review executive action and ensure that the government and administration act in conformity with the law.
7	Independent courts usually manage to control whether the government and administration act in conformity with the law.
4	Courts are independent, but often fail to ensure legal compliance.
1	Courts are biased for or against the incumbent government and lack effective control.

To what extent is there a working separation of powers (checks and balances)?

This question refers to the basic configuration and operation of the separation of powers (institutional differentiation, division of labor according to functions and, most significantly, checks and balances).

Score	Description
10	There is a clear separation of powers with mutual checks and balances.
7	The separation of powers generally is in place and functioning. Partial or temporary restrictions of checks and balances occur, but a restoration of balance is sought.
4	One branch, generally the executive, has an ongoing and either informally or formally confirmed monopoly on power, which may include the colonization of other powers, even though they are institutionally differentiated.
1	There is no separation of powers, neither de jure nor de facto.

To what extent do government authorities ensure well-defined property rights and regulate the acquisition, benefits, use, and sale of property?

Score	Description
10	Property rights and regulations on acquisition, benefits, use, and sale are well defined and enforced. Property rights are limited, solely and rarely, by overriding rights of constitutionally defined public interest.
7	Property rights and regulations on acquisition, benefits, use, and sale are well defined, but occasionally there are problems with implementation and enforcement under the rule of law.
4	Property rights and regulations on acquisition, benefits, use, and sale are defined formally in law, but they are not implemented and enforced consistently nor safeguarded adequately by law against arbitrary state intervention or illegal infringements.
1	Property rights and regulations on acquisition, benefits, use, and sale are not defined in law. Private property is not protected.

2. Transparency / Accountability

Corruption prevention: To what extent are public officials prevented from abusing their position for private interests?

This question addresses how the state and society prevent public servants and politicians from accepting bribes by applying mechanisms to guarantee the integrity of officeholders: auditing of state spending; regulation of party financing; citizen and media access to information; accountability of officeholders (asset declarations, conflict of interest rules, codes of conduct); transparent public procurement systems; effective prosecution of corruption.

Description	Score
Legal, political, and public integrity mechanisms effectively prevent public officeholders from abusing their positions.	10, 9
Most integrity mechanisms function effectively and provide disincentives for public officeholders willing to abuse their positions.	8, 7, 6
Some integrity mechanisms function, but do not effectively prevent public officeholders from abusing their positions.	5, 4, 3
Public officeholders can exploit their offices for private gain as they see fit without fear of legal consequences or adverse publicity.	2, 1

To what extent are the media independent from government?

This question asks to what extent the media are subject to government influence and the influence of actors associated with the government. The question focuses both on media regulation and government intervention. The rules and practice of supervision should guarantee sufficient independence for publicly owned media. Privately owned media should be subject to licensing and regulatory regimes that ensure independence from government.

Description	Score
Public and private media are independent from government influence; their independence is institutionally protected and respected by the incumbent government.	10, 9
The incumbent government largely respects the independence of media, but the regulation of public and/or private media does not provide sufficient protection against potential government influence.	8, 7, 6
The incumbent government seeks to ensure its political objectives indirectly by influencing the personnel policies, organizational framework, or financial resources of public media, and/or the licensing regime/market access for private media.	5, 4, 3
Major media outlets are frequently influenced by the incumbent government promoting its partisan political objectives. To ensure pro-government media reporting, governmental actors exert direct political pressure and violate existing rules of media regulation.	2, 1

To what extent does the government enable the participation of civil society in the political process?

This question asks whether the political leadership involves civil society actors in agenda setting, policy formulation, deliberation, decision-making, policy implementation, and performance monitoring. Civil society actors include civic, economic, and professional interest associations, religious, charity and community-based organizations, intellectuals, scientists, and journalists.

Description	Score
The political leadership actively enables civil society participation. It assigns an important role to civil society actors in deliberating and determining policies.	10, 9
The political leadership permits civil society participation. It takes into account and accommodates the interests of most civil society actors.	8, 7, 6
The political leadership neglects civil society participation. It frequently ignores civil society actors and formulates its policy autonomously.	5, 4, 3
The political leadership obstructs civil society participation. It suppresses civil society organizations and excludes their representatives from the policy process.	2, 1

3. Social Cohesion

To what extent is exclusion and decoupling from society effectively prevented?

Reducing the various risks of social exclusion is a fundamental precondition for social cohesion and stability. The country assessment should focus on the following key questions: 1) To what extent is poverty effectively prevented? 2) To what extent are there enabling conditions for equal opportunity in society? In addition to poverty, please also take into account additional dimensions of exclusion like the experience of marginalization and the desire to be appreciated when evaluating socioeconomic disparities.

Reference Indicators: *Poverty rates | Gini Coefficient*

Description	Score
Policies very effectively enable societal inclusion and ensure equal opportunities.	10
	9
	8
For the most part, policies enable societal inclusion effectively and ensure equal opportunities.	7
	6
	5
For the most part, policies fail to prevent societal exclusion effectively and to ensure equal opportunities.	4
	3
	2
Policies exacerbate unequal opportunities and exclusion from society.	1

How strong is the citizens' approval of political institutions and procedures?

Please base your assessment on public opinion survey data, addressing the following factors:

- approval of the political system
- approval of performance (measured by how the political institutions function in practice or the satisfaction with the working of the institutions)
- approval of political institutions (often measured by the level of trust in institutions such as government, the legal system and police, state bureaucracy, political parties, and the military)

Description	Score
Approval of political institutions and procedures is very high.	10
	9
	8
Approval of political institutions and procedures is fairly high.	7
	6
	5
Approval of political institutions and procedures is fairly low.	4
	3
	2
Approval of political institutions and procedures is very low.	1

To what extent is there a network of cooperative associations to mediate between society and the political system?

This question addresses the representation of societal interests in the political system. In evaluating the systemic nature and the quality of representative patterns, please consider:

- the spectrum of interest groups, ranging from social movements and community organizations to unions and professional associations
- the capacity to incorporate all (competing) societal interests and to avoid the dominance of a few strong interests
- the degree of cooperation between different interest groups

Description	Score
There is a broad range of interest groups that reflect competing societal interests, tend to balance one another, and are cooperative.	10
	9
	8
There is an average range of interest groups, which reflect most societal interests. However, a few strong interests dominate, producing a latent risk of pooling conflicts.	7
	6
	5
There is a narrow range of interest groups, in which important societal interests are underrepresented. Only a few players dominate, and there is a risk of polarization.	4
	3
	2
Interest groups are present only in isolated social segments, are on the whole poorly balanced and cooperate little. A large number of societal interests remain unrepresented.	1

To what extent is the government able to moderate domestic economic, political, and social conflicts?

Please assess the extent to which the government is able to depolarize structural conflicts, to prevent society from falling apart, and establish as broad a consensus as possible across the dividing lines.

Description	Score
The government depolarizes conflicts and expands consensus across the dividing lines.	10
	9
	8
The government prevents conflicts from escalating.	7
	6
	5
The government does not prevent conflicts from escalating.	4
	3
	2
The government exacerbates existing conflicts for populist or separatist purposes.	1

4. Future Resources

To what extent does education policy deliver high-quality, efficient, and equitable education and training?

This question assesses the extent to which a government's education policy facilitates high-quality learning that contributes to personal development, sustainable economic growth, and social cohesion. Your response should focus on the following, irrespective of the education system's organization: the contribution of education policy towards providing a skilled labor force, the graduate output of upper secondary and tertiary education, and (equitable) access to education. While the latter pertains to issues of fairness and distributive justice, it also has implications for a country's international competitiveness as unequal education implies a waste of human potential.

Reference Indicators: *PISA results | education spending | attainment levels*

To what extent does research and innovation policy support technological innovations that foster the creation and introduction of new products and services?

This question comprises subsidies and incentives for research institutions conducting basic and applied research, as well as subsidies and incentives for establishing start-up companies that transfer scientific output into products and enhanced productivity. Bureaucratic impediments to research and innovation should also be taken into account.

Reference Indicators: *R&D spending | Science and Technology Degrees | Patents | R&D Personnel*

How successful is a government in reducing unemployment and in increasing employment?

This question addresses a government's strategies to reconcile the following objectives: unemployment reduction and job security, and balancing supply and demand on the labor market by providing sufficient mobility of the labor force according to the needs of potential employers in order to increase the level of employment. To assess labor market and employment policy comprehensively, special emphasis should be placed on the positive or detrimental effects resulting from labor market regulation (e.g., dismissal protection, minimum wages, collective agreements) and from the modus operandi of unemployment insurance).

To what extent are social security schemes based on principles of fiscal sustainability?

This question seeks to assess the extent to which social security schemes (e.g. pension systems, health care insurance, unemployment insurance etc.) are fiscally sustainable. This question is essential for assessing a government's room to maneuver in paying its current financial obligations without shifting the cost to future generations.

To what extent are environmental concerns effectively taken into account in both macro- and microeconomic terms?

This question seeks to assess the extent to which externalization of costs or inadequate time horizons are avoided or restrained by environmental regulation. In macroeconomic terms, please determine whether tax and energy policies take ecological goals and measures into account (e.g. promotion of renewable energies, CO^2 reduction goals). In microeconomic terms, please establish whether the government sets incentives for environmentally sound consumption and investments to households and companies. Please take into account that a deeply engrained awareness of the environment or nature in society may serve as a functional equivalent.

Reference Indicators: *CO^2 emissions | Environmental Performance Index*

II. STEERING CAPABILITY AND REFORM CAPACITIES

5. Strategic Capacity

Prioritization: To what extent does the government set and maintain strategic priorities?

This question seeks to assess:

- the political capability to take on a longer-term perspective going beyond immediate concerns of electoral competition, to maintain strategic priorities over periods of crisis and stalemate
- the strategic capacity of the government to prioritize and organize its policy measures (gaining and organizing expertise, evidence-based policy-making, regulatory impact assessment, strategic planning units)

Make sure to identify reform drivers and defenders of the status quo, as political determination and institutional capacity may vary among different departments and ministries. Please also comment on how setting and maintaining strategic priorities might be constrained by government composition and by actors outside the government (e. g. powerful economic interests, lobbies, foreign governments, foreign donors).

Description	Score
The government sets strategic priorities and maintains them over extended periods of time. It has the capacity to prioritize and organize its policy measures accordingly.	10, 9
The government sets strategic priorities, but sometimes postpones them in favor of short-term political benefits. It shows deficits in prioritizing and organizing its policy measures accordingly.	8, 7, 6
The government claims to be setting strategic priorities, but replaces them regularly with short-term interests of political bargaining and office seeking. Policy measures are rarely prioritized and organized.	5, 4, 3
The government does not set strategic priorities. It relies on ad hoc measures, lacks guiding concepts, and reaps the maximum short- term political benefit.	2, 1

Policy coordination: To what extent can the government coordinate conflicting objectives into a coherent policy?

As many policies have conflicting objectives, reflect competing political interests and affect other policies, the government has to ensure that its overall policy is coherent. Successful coordination should:

- assure that trade-offs between policy goals are well balanced
- introduce horizontal forms of coordination to mediate between different departments of the state administration
- ascribe responsibilities in a transparent manner to avoid the negligence of tasks, redundancies, or friction between different government branches.

Various coordination styles (hierarchic-bureaucratic, informal-network, personalist, centralized, decentralized etc.) are possible and may be functionally equivalent. What matters is their impact on policy coherence.

Description	Score
The government coordinates conflicting objectives effectively and acts in a coherent manner.	10, 9
The government tries to coordinate conflicting objectives, but with limited success. Friction, redundancies, and gaps in task assignments are significant.	8, 7, 6
The government mostly fails to coordinate between conflicting objectives. Different parts of the government tend to compete among each other, and some policies have counterproductive effects on other policies.	5, 4, 3
The government fails to coordinate between conflicting objectives. Its policies thwart and damage each other. The executive is fragmented into rival fiefdoms that counteract each other.	2, 1

Stakeholder Involvement: To what extent does the government consult with major economic and social interest groups to support its policy?

This question assesses how successfully the government consults with economic and social actors in preparing its policy. Successful consultation is conceived here as an exchange of views and information that increases the quality of government policies and induces economic and social actors to support them.

Description	Score
The government successfully motivates economic and social actors to support its policy.	10, 9, 8
The government facilitates the acceptance of its policy among economic and social actors.	7, 6, 5
The government consults with economic and social actors.	4, 3, 2
The government hardly consults with any economic and social actors.	1

Political Communication: To what extent does the government actively and coherently communicate and justify the rationale for and goals of its policies to the public?

A coherent communication policy is an important aspect of strategic governance, and ultimately in winning public acceptance for governmental policies. This question assesses governments' public communication efforts, and the extent to which policy-makers are able to coherently describe and justify goals and programs to the public.

Description	Score
The government effectively coordinates its communication efforts and it coherently communicates and justifies the goals of its policies to the public.	10, 9
The government seeks to coordinate its communication efforts. Contradictory statements are rare, but do occur sometimes. In most cases, the government is able to coherently communicate and justify the goals of its policy to the public.	8, 7, 6
The government has problems in effectively coordinating its communication efforts. Statements occasionally contradict each other. The government is only partly able to coherently communicate and justify the goals of its policies to the public.	5, 4, 3
The government fails to coordinate its communication efforts. Statements often contradict each other. The government is not able to coherently communicate and justify the goals of its policies to the public.	2, 1

6. Implementation and Efficiency

To what extent can the government achieve its own policy objectives?

This question seeks to evaluate a government's implementation performance against the performance benchmarks set by the government for its own work. The assessment should therefore focus on the major policy priorities identified by a government and examine whether declared objectives could be realized.

Description	Score
The government can largely implement its own policy objectives.	10, 9, 8
The government is partly successful in implementing its policy objectives or can implement some of its policy objectives.	7, 6, 5
The government partly fails to implement its objectives or fails to implement several policy objectives.	4, 3, 2
The government largely fails to implement its policy objectives.	1

To what extent does the government make efficient use of available human, financial, and organizational resources?

In assessing the government's resource efficiency, please focus on the executive, including the administration and the cabinet.

Reference Indicators: Personnel expenses relative to the services offered by the state | low number of politically motivated dismissals and new appointments of public servants | competitive recruiting procedures protected against political influence | transparent budget planning and implementation | low deviation of actual budget expenditures from the associated planned expenditures | effective and independent auditing | public administration that enables effective management under criteria of professional rationality | procedures and institutions to reform and modernize public administration.

Description	Score
The government makes efficient use of all available human, financial, and organizational resources.	10, 9, 8
The government makes efficient use of most available human, financial, and organizational resources.	7, 6, 5
The government makes efficient use of only some of the available human, financial, and organizational resources.	4, 3, 2
The government wastes all available human, financial, and organizational resources.	1

7. Adaptability

Policy Learning: How innovative and flexible is the government?

Innovation in policy-making often comes from learning. This learning goes beyond changes in policy outputs to include changes in the basic beliefs in guiding policy formulation. Learning opportunities are provided by:

- learning from past experience (effective internal monitoring and evaluation)
- observation and knowledge exchange (good practices, international cooperation)
- consultancy (academic experts and practitioners)

Flexibility refers to a government's ability to adapt to and take advantage of development opportunities inherent to a given political situation. Flexibility and learning allow governments to replace failed policies with innovative ones. If possible, provide empirical evidence on whether policy learning happens coincidentally or if there are institutionalized mechanisms that facilitate innovation and flexibility in policy-making.

Description	Score
The government demonstrates a pronounced ability for complex learning. It acts flexibly and replaces failed policies with innovative ones.	10, 9, 8
The government demonstrates a general ability for policy learning, but its flexibility is limited. Learning processes inconsistently affect the routines and the knowledge foundation on which policies are based.	7, 6, 5
The government demonstrates little willingness or ability for policy learning. Policies are rigidly enforced, and the routines of policy-making do not enable innovative approaches.	4, 3, 2
The government demonstrates no willingness or ability for policy learning.	1

Institutional Learning: To what extent does the government improve its strategic capacity by changing the institutional arrangements of governing?

Strategic capacity is the capacity to take and implement political decisions that take into account the externalities and interdependencies of policies, are based on scientific knowledge, promote the common goods and represent a long-term orientation. Institutional arrangements include the rules of procedure and the work formats defined there, in particular the cabinet, the office of the head of government, the center of government, the portfolio of ministries, the advisory staffs of ministers, and the head of government as well as the management of relations with parliament, governing parties, ministerial administration, and public communication.

Description	Score
The government improves considerably its strategic capacity by changing its institutional arrangements.	10, 9, 8
The government improves its strategic capacity by changing its institutional arrangements.	7, 6, 5
The government does not improve its strategic capacity by changing its institutional arrangements.	4, 3, 2
The government loses strategic capacity by changing its institutional arrangements.	1

III. TRACK RECORD OF PAST CRISIS MANAGEMENT (IF APPLICABLE)

- Is there evidence from historical events that the country and its society have already mastered economic and political shocks in the past?
- Does the political system facilitate crisis remediation in a timely manner?
- Is the signaling process between decision makers (government, central bank, employers, employee representatives) so well established that confusion about (and resistance to) the expected outcome of decisions by one decision maker on the others can be avoided or at least minimized?
- Are there constitutionally anchored and politically accepted procedures for sequencing and timing of countermeasures in a crisis?
- Are precautionary measures (e.g., deposit insurance, foreclosure procedures) in place that can protect the most vulnerable groups against the full effect of a crisis?
- Are automatic stabilizers in fiscal policies sufficiently strong to contain surges of massive unemployment?

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