Macroeconomic
and Country Risk Outlook

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Half-baked recovery

Economic Research

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Contents

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Economic
Outlook
no. 1199

Macroeconomic
and Country Risk Outlook

3 **EDITORIAL**

4 **OVERVIEW**

12 **COUNTRY RISK OUTLOOK**

14 ■ **North AMERICA**
Focus United States ■ Hopes for modest improvement in 2014

15 ■ **Latin AMERICA**
Focus Brazil ■ Growth below potential

16 ■ **EUROzone**
Focus Southern Europe ■ Partly cloudy

17 ■ **Emerging EUROPE**
Focus Turkey ■ Still vulnerable

18 ■ **AFRICA - Middle EAST**
Focus Saudi Arabia ■ Not based on shifting sands
Focus South Africa ■ Digging deep

19 ■ **ASIA-Pacific**
Focus Japan ■ Dynamic in 2013, resilient in 2014

20 **ECONOMIC OUTLOOK SERIES**

21 **OTHER AVAILABLE PUBLICATIONS**

22 **SUBSIDIARIES**

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Publication Director and Chief Economist: Ludovic Subran
Macroeconomic Research and Country Risk: Silvia Pepino (Head), Andrew Atkinson, Ana Boata, Mahamoud Islam, Emma Ménascé, Dan North, Manfred Stamer (Country Economists), Nicolas Bargas, Rémy Carasse and Clémentine Cazalets (Research Assistants)
Sector and Insolvency Research: Maxime Lemerle (Head), Bruno Goutard, Yann Lacroix, Marc Livinec, Didier Moizo (Sector Advisors)
Editor : Martine Benhadj
Graphic Design : Claire Mabille
Support : Laetitia Giordanella
For further information, contact the Economic Research Department of Euler Hermes at 1, place des Saisons 92048 Paris La Défense Cedex – Tel.: +33 (0) 1 84 11 41 15 – e-mail: research@euler-hermes.com > Euler Hermes is a limited company with a Directoire and Supervisory Board, with a capital of 14 468 072,64 EUR, RCS Paris B 388 236 853
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EDITORIAL

Keeping faith in the J curve

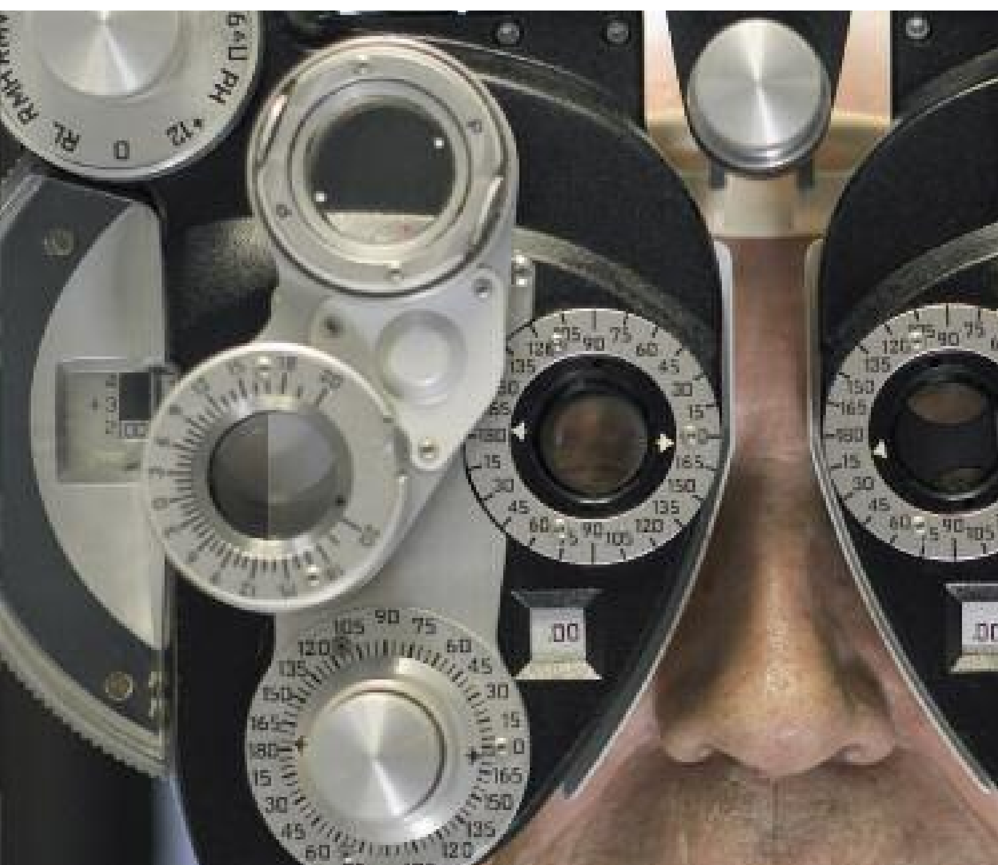
LUDOVIC SUBRAN

In economics, the J curve describes the effect of a depreciation of the exchange rate on the trade balance over time. At the outset, the idea is simple: following the depreciation of a country's currency, the price of imports increases and the price of exports decreases; the current account balance worsens, and we reach the trough of the J. Since domestic products have become more competitive, exports pick up and, at the same time, imports decrease because foreign products are now more expensive. The current account balance recovers and surpasses its starting point, or the bar of the J. Many economic policies have the effect of an initial deterioration (particularly on the fiscal deficit) and count on a recovery phase (growth) but everything then depends on the shape of the J. In 2014, many economies will see whether their J has done its loop and is now onto the stem or, in other words, whether the recovery will finally materialize and heal the scars of the crisis after the efforts made. Austerity cures, private sector deleveraging, financing shortfalls, cleaning up banks, fighting inflation and containing credit risk, developed countries and emerging countries are all at a pivotal moment where the J should finally begin to take shape. And yet... Like for the Marshall-Lerner condition (describing the theoretical parameters of a successful devaluation), many conditions (here beyond simple price elasticities) will determine the shape and the strength of the curve. Negotiating the bend of the J will be all the more difficult the more the end of accommodating monetary policies is abrupt, the longer household and business confidence takes to materialize in investments and the more the risks of a credit crunch are not contained. So what can be done so that the J does not turn into an L, so that the W (the end of the double dip) is clear-cut, and so that each country and each company rediscovers the ABCs of growth? First of all it needs to be accepted that the recovery will not be risk-free and risks still need to be hedged. The risk of non-payment for companies will remain particularly high in Europe (due to demand) and in emerging countries (due to financing problems in the countries with large external deficits). Next, growth needs to continue to be consolidated all the while risk-taking is diversified. This may translate into decisions to export further afield (to decouple risks), to raise financing in an innovative way or simply once again to revise budgets (and therefore expenditures). Last, be alert as to the automatic effect of confidence: self-fulfilling prophecies may be necessary to get to the other side, but beware of false good news!

OVERVIEW

Half-baked **recovery**

ANA BOATA, CLÉMENTINE CAZALETS, MAHAMOUD ISLAM



With the participation of **Marc Livinec**

We have revised (1) slightly upwards our growth forecasts for developed countries in 2014 (to +2.1%), owing to improved prospects in the United States (+2.8%), Japan (+1.5%) and the eurozone (+0.9%), and (2) slightly downwards our forecasts for emerging countries (+4.6%) due to a slowdown in growth in Latin America and Asia. Growth in developed countries is likely to be curbed by the lack of any real recovery in the investment cycle (especially in the eurozone), combined with still-weak household consumption.

Although the pace of budgetary consolidation should slow in the coming quarters (in the eurozone and the United States), the delayed effects of tax hikes, rising unemployment rates and household deleveraging can be expected to weigh on growth (notably in the eurozone).

Risks remain tilted on the downside

(1) Refinancing needs in the Southern European countries and the end of financial assistance to Portugal, Ireland, Greece and Spain (for banks) could give rise to fresh tensions in financial markets. Similarly, the debate on the public debt ceiling in the United States, which is likely to be reached in mid-October, as well as the government shutdown affecting a number of public services continues to dent the US gov-

ernment's credibility.

(2) In geopolitical terms, an escalation of political tensions with Iran and Syria could lead to major loss of life and a complete destabilization of the region, in addition to a shock on oil prices.

Despite the slowdown in growth in emerging countries, they will remain the biggest contributors to global growth. However, prospects remain fragile, as illustrated by the concerns sparked during the summer of 2013: (1) downward revision of growth forecasts, (2) acceleration of capital outflows as a result of expectations of a slowdown in the US quantitative easing (QE) program since May. While tensions seem to have eased during September (gradual return of capital and stabilization of currencies) following the Fed's meeting announcing the postponement of the tapering, it is too soon to celebrate. The risk of an emerging-country crisis, ▶

+3.0%

Global GDP growth in 2014

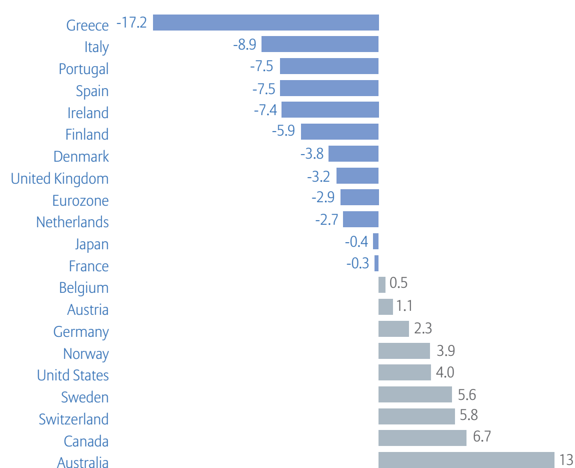
GDP growth, %

	Share*	2011	2012	2013_f	2014_f
World GDP growth	**100**	**2.9**	**2.6**	**2.2**	**3.0**
Developed countries	**62**	**1.6**	**1.4**	**1.1**	**2.1**
Emerging countries	**38**	**5.2**	**4.5**	**4.1**	**4.6**
North America	**24**	**1.9**	**2.7**	**1.7**	**2.8**
United States	**22**	**1.8**	**2.8**	**1.6**	**2.9**
Canada	3	2.5	1.7	1.8	2.5
Latin America	**8**	**4.2**	**2.6**	**2.7**	**2.9**
Brazil	3	2.7	0.9	2.2	2.0
Western Europe	**23**	**1.5**	**-0.3**	**-0.1**	**1.1**
United Kingdom	3	1.1	0.2	1.1	1.6
Sweden	1	3.8	1.1	1.1	2.3
Eurozone	**17**	**1.5**	**-0.5**	**-0.5**	**0.9**
Germany	5	3.1	0.9	0.5	1.6
France	4	2.0	0.0	0.2	0.6
Italy	3	0.5	-2.4	-1.8	0.3
Spain	2	0.4	-1.6	-1.5	0.4
Netherlands	1	1.1	-1.3	-1.2	0.8
Greece	0	-7.1	-6.4	-4.1	-0.3
Ireland	0	2.2	0.1	-0.3	1.4
Portugal	0	-1.6	-3.2	-1.9	0.4
Central and Eastern Europe	**6**	**4.7**	**2.1**	**1.7**	**3.0**
Russia	3	4.3	3.4	2.0	3.5
Turkey	1	8.8	2.2	3.3	4.0
Poland	1	4.5	1.9	1.0	2.2
Asia	**29**	**4.7**	**4.9**	**4.7**	**4.9**
China	11	9.3	7.7	7.4	7.6
Japan	8	-0.5	2.0	2.0	1.5
India	3	6.3	5.0	4.7	5.5
Oceania	**2**	**2.3**	**3.3**	**2.2**	**2.6**
Australia	2	2.4	3.7	2.4	2.8
Middle East	**4**	**4.6**	**3.6**	**2.4**	**3.7**
Saudi Arabia	1	8.5	6.8	4.0	4.5
United Arab Emirates	1	3.9	4.4	3.5	4.0
Africa	**2**	**1.1**	**5.7**	**4.1**	**4.9**
South Africa	1	3.5	2.5	2.5	3.5
Morocco	0	5.0	2.7	4.5	4.5

Sources: IHS Global Insight, Euler Hermes forecasts
(*) 2012, GDP weighted at current exchanges rates, %

Change in real GDP level

Q2 2013 compared to Q1 2008, %



Sources: National Statistics, IHS Global Insight

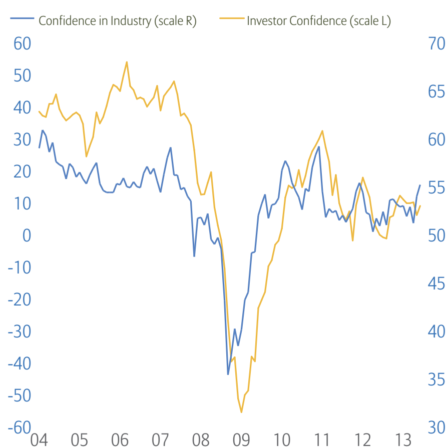
like the one that started in 1997, remains small, as emerging countries have more tools to manage financial instability (foreign exchange reserves and, above all, credible monetary policies). However, in order to completely restore investor confidence, priority will need to be given to (1) reducing external imbalances (particularly in Indonesia and Turkey), and (2) pressing ahead with structural reforms to spur more sustainable growth.

Against this backdrop, global growth is forecast to come in at +2.2% in 2013 (after +2.6% in 2012) and to accelerate moderately in 2014 (+3.0%). Growth in global trade is expected to remain below past levels (+1.9% in 2013 and +4.5% in 2014, compared with a long-term average of +5.1%) due to a slowdown in activity in Latin America and, notably, in Asia.

+4.5%

Global trade growth in 2014

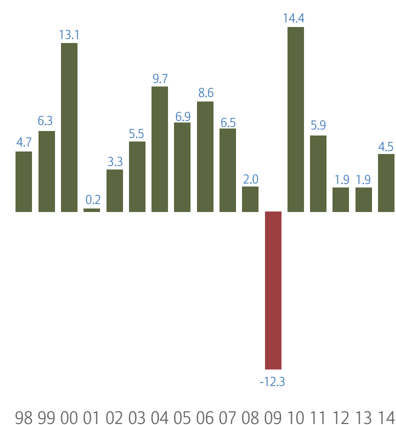
World business cycle indicators



Sources: Markit, Sentix, Euler Hermes

World trade in goods and services

Yearly change, in %

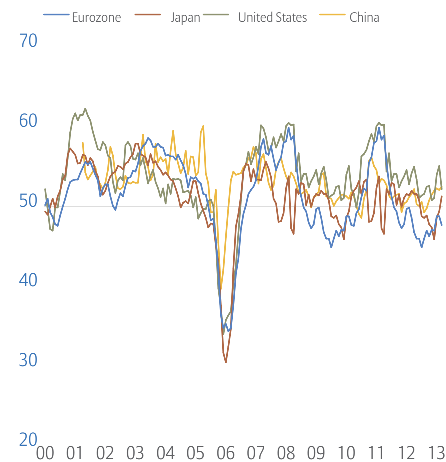


Sources: National Statistics, CPB, Euler Hermes forecasts

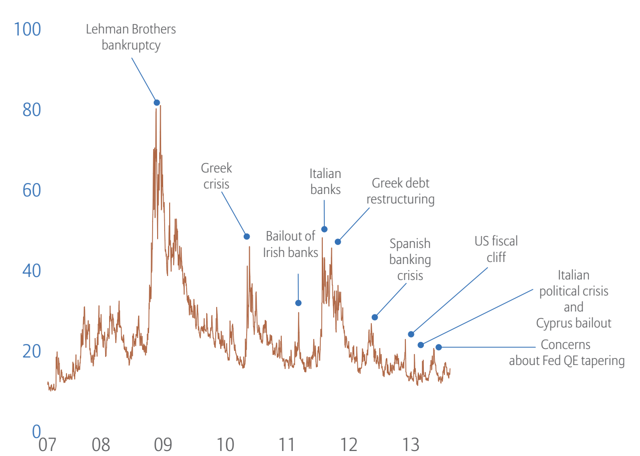
Contribution to 2013 GDP growth

	GDP =	Domestic demand	+ Net trade contribution
Australia	2.4%	0.7%	1.7%
Japan	2.0%	1.8%	0.2%
Canada	1.8%	1.6%	0.2%
Switzerland	1.7%	0.9%	0.8%
United States	1.6%	1.6%	0.1%
Norway	1.1%	1.9%	-0.8%
United Kingdom	1.1%	0.9%	0.2%
Sweden	1.1%	1.0%	0.1%
Germany	0.5%	0.7%	-0.2%
Austria	0.4%	-0.7%	1.2%
Denmark	0.4%	0.5%	-0.2%
France	0.2%	0.1%	0.1%
Belgium	0.0%	-0.4%	0.5%
Ireland	-0.3%	-0.7%	0.4%
Finland	-1.0%	-3.4%	2.4%
Netherlands	-1.2%	-2.6%	1.4%
Spain	-1.4%	-3.3%	2.0%
Italy	-1.8%	-2.8%	0.9%
Portugal	-1.9%	-3.9%	2.0%
Greece	-4.1%	-6.3%	2.2%

Sources: IHS Global Insight, Euler Hermes estimates



Sources: Markit, Bloomberg, Euler Hermes



Sources: Bloomberg, Euler Hermes

+0.9%

GDP growth in the eurozone in 2014

Unemployment rate (*)

	2012	2013f	2014f
Greece	24.2%	26.5%	27.0%
Switzerland	2.8%	3.0%	3.0%
Japan	4.3%	4.3%	4.6%
Sweden	8.0%	8.4%	8.0%
Portugal	15.9%	17.7%	18.4%
Ireland	14.7%	14.2%	13.8%
Norway	3.2%	3.3%	3.2%
Canada	7.3%	7.1%	6.9%
United States	8.1%	7.7%	7.0%
France	10.3%	10.9%	10.9%
Italy	10.7%	12.0%	12.9%
Spain	24.9%	26.0%	26.4%
Denmark	7.7%	6.9%	6.0%
Belgium	7.6%	8.6%	8.6%
Germany	6.5%	6.6%	6.5%
Eurozone	11.5%	12.2%	12.9%
Austria	4.4%	4.7%	4.6%
Finland	7.7%	8.0%	7.8%
Netherlands	6.4%	8.3%	8.6%
Australia	5.2%	5.1%	4.7%
United Kingdom	8.0%	7.8%	7.7%
Brazil	5.5%	5.4%	5.4%
Russia	5.1%	5.4%	5.2%
India	8.1%	8.4%	8.2%

(*) Annual average
Sources: IHS Global Insight, Euler Hermes forecasts

Eurozone

> Confidence is returning in the eurozone, but downside risks linger over our scenario.

GDP growth in the eurozone countries is expected to stabilize in the second quarter of 2013 on the back of an improvement in the business climate, better prospects for order books (notably for exports) and a smaller contraction in domestic demand. Nevertheless, divergences between the region's countries persist, with Germany growing moderately, France near stagnation and the Southern European countries still in recession. Overall, activity growth in the eurozone will remain modest (+0.9% in 2014 after -0.5% in 2013), driven by exports but held back by weak domestic demand, hit by a lack of business financing, private-sector deleveraging, rising unemployment rates and budgetary consolidation.

> At the eurozone governance level, the road to financial integration remains long.

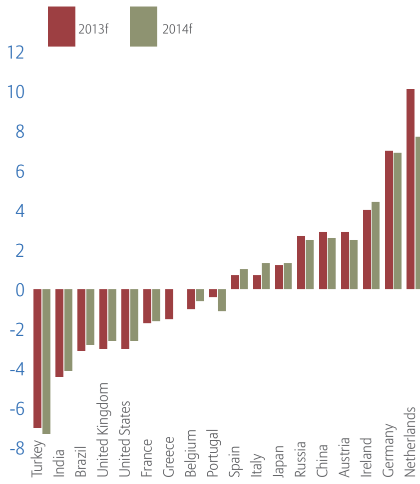
After the agreement from the European Parliament, the Single Supervisory Mechanism (SSM) is expected to be operational in H2 2014. The ECB will publish its first Asset Quality Review (AQR) for the banks under single European supervision at the beginning of 2014. The European Banking Authority (EBA) will conduct a test focused on liquidity (and no longer on the solvency of banks, as was the case previously) in the same period. All this should bolster confidence in the solidity of the European financial system and, once the bank supervisor is up and running, pave the way for the direct recapitalization of solvent banks by the ESM in order to break the vicious circle between banks and sovereigns. The ECB is expected to announce support measures (new LTROs) towards the end of 2013 or early 2014 in order to assuage banks' reluctance to offer credit to the private sector. Negotiations over the implementation of the second pillar of the banking union (the Single Resolution Mechanism, comprising a bank resolution authority and a common resolution fund) are ongoing and do not promise to be straightforward. Implementation is not expected before 2015. The introduction of a common deposit guarantee scheme seems to have been sidelined. The end of several adjustment programs (Ireland, Portugal, Greece and Spain), at a time when market conditions are still not favorable enough to ensure future financing needs are met, could give rise to fresh tensions in the markets. All eyes will be on the conclusions of the Troika's missions in Ireland and Greece to be given in October.

> The political context remains a key factor for eurozone governance.

The new governing coalition in Germany will be crucial for the eurozone's governance. A coalition between the center-right CDU/CSU (Angela Merkel's party) and the center-left (SPD) seems to be the most likely scenario and talks are under way. Should this eventuate, it would probably have positive effects for the eurozone, as the center-left party seems more open to (1) ▶

Current account balance

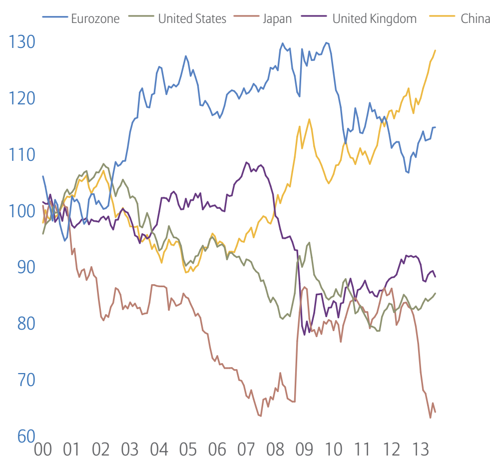
% of GDP



Sources: IHS Global Insight, Euler Hermes forecasts

Exchange rates

Real effective exchange rate, basis 100=Q1 2000



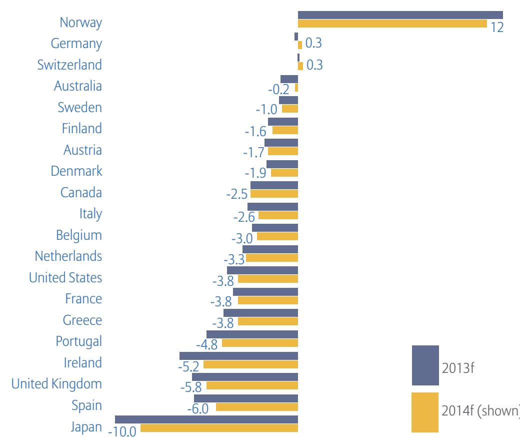
Sources: IHS Global Insight, Euler Hermes

implementing a fiscal union and mutualizing public debt in the eurozone (European Redemption Fund), and (2) a fiscal policy in favor of preserving growth and employment. The recent tensions within the Italian governing coalition provide confirmation of a tense political environment and increase the risk of new elections by the year's end. The markets could penalize the delayed implementation of structural reforms and a possible budget overrun (even if limited) following the delayed implementation of austerity measures needed to reach the official fiscal deficit target.

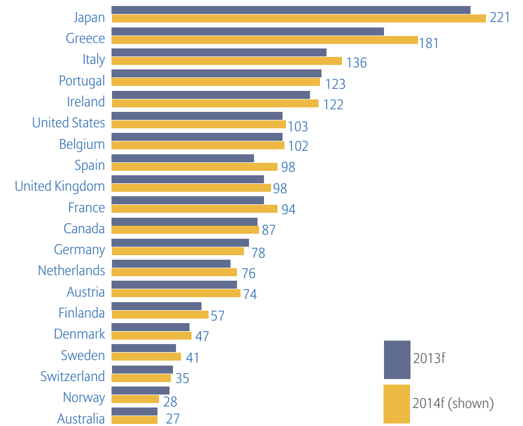
United States

> The United States is showing signs of resilience despite the budgetary consolidation. 2014 should see a more pronounced recovery in growth.

US growth has remained modest in recent years (we expect +1.6% in 2013) and below its post-war average (+3.3%) given the weak recovery in the labor market (the structural unemployment rate remains at very high levels) and the impact of austerity measures. In 2014, the housing market is expected to continue to pick up, although the recent rise in interest rates could take the wind out of its sails. The manufacturing sector should remain buoyant, helped by re-



Sources: National Statistics, Euler Hermes forecasts



Sources: National Statistics, Euler Hermes forecasts

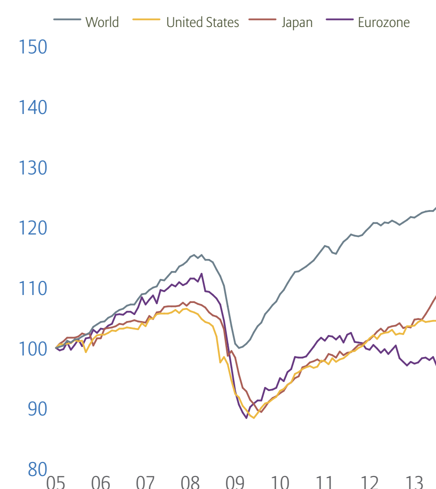
+2.9%

GDP growth
in the United States
in 2014

newed competitiveness and low energy costs. The Fed will probably continue to bolster the economy with its quantitative easing program: a slowdown in bond purchases is expected in late 2013 or early 2014, but a complete stop is unlikely before H2 2014.

> Political paralysis has not been averted; the risk of the United States failing to reach an agreement on the debt ceiling, and thus of technical default, is not zero.

The fiscal year began on October 1 and, on this date, Congress and the House of Representatives had to have found the means to finance government operations. Unfortunately, agreement was not found and government shutdown affecting a number of services were not averted. This has taken place before, in 1995 and 1996 when Bill Clinton was president, and at episode showed that the negative effects could remain contained if the situation lasts no longer than two to three weeks. More worryingly, the debt ceiling is likely to be reached in mid-October and, in the event of no agreement from Congress, a technical default could be declared. A last-minute deal remains our core scenario.



Sources: IHS Global Insight, Euler Hermes forecasts

JAPAN

> Abenomics is bearing fruit in Japan.

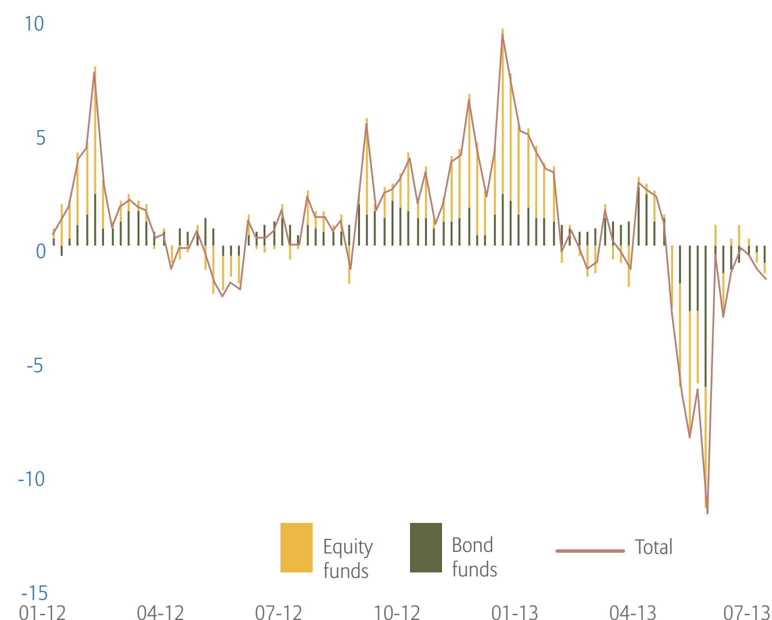
Since the beginning of the year, GDP growth has surprised positively thanks to brisk domestic demand and export growth. For the full year 2013, growth is forecast to reach +2.0% before slowing slightly in 2014 (+1.5%) under the effect of budgetary consolidation measures to contain the slide in public finances (at end-2012 the fiscal deficit had reached -9.9% of GDP and the public debt 212% of GDP). The VAT rate will be increased by +3 percentage points in April 2014 (to 8%). Growth is expected to be underpinned by a policy mix that remains favorable, combining the continuation of the BoJ's monetary policy (doubling of the money supply by 2014) and fiscal stimulus (JPY 10 trillion for the time being; another JPY 5 trillion being negotiated).

> The time for reforms has come!

In the medium term, the Japanese government should adopt a range of structural reforms, Abenomics' third arrow, including bolstering the private sector's potential for growth, an improvement of labor market, and the development of new high-tech industries in order to make ▶

growth more sustainable. Public finances will have to be rebalanced in parallel and the government will have to adopt a credible stance. Our view is that, at present, the goal of cutting spending by JPY 8 trillion in two years (i.e. -4% of current budget spending) is ambitious given the stimulus measures already announced by the government and the fragility of the Japanese recovery (essentially relying on fiscal and monetary stimulus).

Emerging markets, net capital flows
Billion USD



Sources: OECD, Euler Hermes

Emerging countries

> The second-round effects from the decoupling of the real economy and the financial markets will reach emerging markets.

Back in June, we highlighted the rise in financial risks as a result of the global decoupling of the real economy and the financial markets (weak economic recovery and low inflation on the one hand and highly positive performances by financial indicators on the other), itself due to excessive global liquidity. At that time we argued that this decoupling would be a source of instability given (1) the ineffectiveness of monetary policy transmission mechanisms, (2) uncertainties overhanging the global economic outlook leading to greater demand for "safe-haven" assets, and (3) speculative behavior on the part of financial institutions in search of high yields in the short term. This diagnosis turned out to be correct and second-round effects are being felt. Since the Fed's announcement of a future slowdown in its bond purchases back in May, emerging countries have been exposed to severe pressures in the currency and equity markets, brought about on the one hand by investor fears of monetary tightening in the United States and, on the other, by financial imbalances in many emerging countries, in particular Indonesia, India, Turkey, Brazil and South Africa (excessive credit growth, external deficits, lack of structural reforms). As capital outflows gathered pace, the currencies of these countries depreciated sharply against the dollar, inflationary pressures increased, equity markets slumped and funding costs rose (bond markets).

> Interventions by domestic governments and central banks dampened the negative effects.

Three types of actions were carried out to restore financial stability in emerging countries: interventions in the currency market, the use of key policy rates and capital controls. The central banks of India and Thailand, for example, intervened in the currency market to sell dollars in order to check the slide in their exchange rates. The central banks of Indonesia, Brazil and Turkey hiked their key policy rates to contain inflationary pressures and attract capital inflows. Brazil eased its capital controls introduced in 2010.

Thus, prospects improved for emerging countries during September (appreciation of exchange rates, renewed capital inflows), while the positive trend was confirmed only after the Fed's announcement on 18 September in favor of keeping the unconventional monetary policies in place. Nevertheless, these past months have clearly underlined the vulnerability of a number of emerging countries and the problems could flare up again in the coming months as long as uncertainty over the Fed's tapering of its quantitative easing program continues to linger.

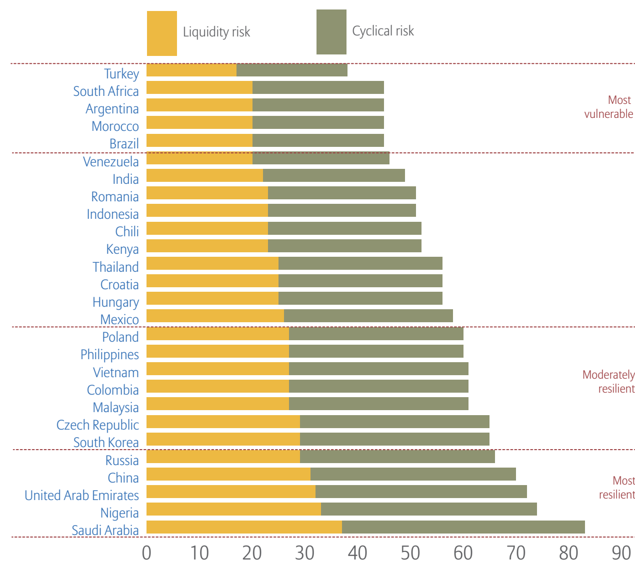
> We identify three groups of countries: the most vulnerable, the resilient and the least vulnerable.

Against this backdrop, the vulnerability of a country depends on two risk categories: cyclical risk and liquidity risk (structural vulnerability). The first encompasses short-term weaknesses: (1) risks overhanging exchange rates and prices, (2) the risk overhanging financial value (financial wealth and stock prices), and (3) dependence on the energy sector. The second category concerns the economy's capacity to weather a liquidity crisis. It can be measured by the level of external accounts (current accounts, debt and foreign reserves) and trends in credit to the private sector.

A comparison of these indicators reveals three groups of countries: (1) the least vulnerable countries (low liquidity risk, low cyclical risk), notably the United Arab Emirates, Saudi Arabia and Nigeria; (2) the resilient countries (low liquidity risk but exposed to cyclical risk), mainly Asian countries such as Malaysia, the Philippines and Thailand; (3) last, the most vulnerable countries (high cyclical risk and high liquidity risk), notably Turkey, South Africa, Argentina and India.

Ranking of emerging economies in terms of resilience

0-100 score (0=highest risk, 100=lowest risk)



Source: Euler Hermes

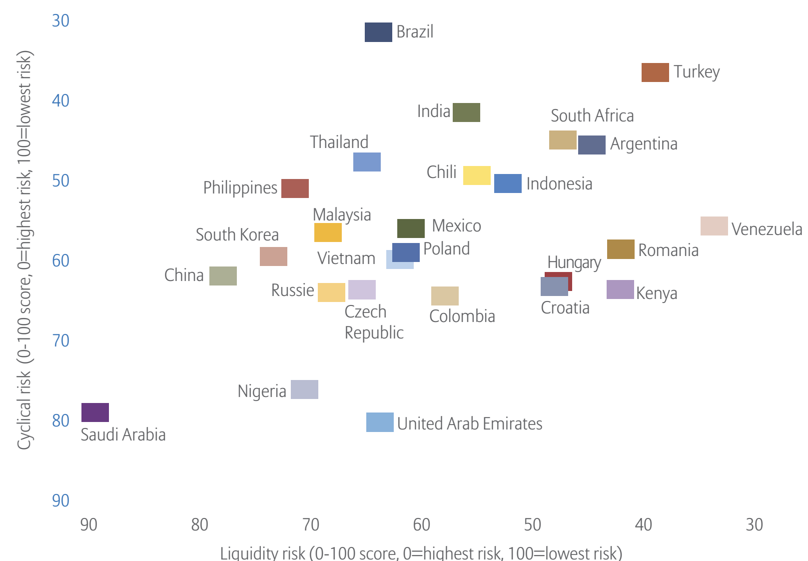
Although the third category is the most vulnerable, we believe the likelihood of a large-scale financial crisis is small. In addition to rather satisfactory growth prospects, these countries have shown (2009 crisis in particular) their capacity to react to a financial crisis in the past. Monetary oversight has become more effective, as illustrated by the actions undertaken as soon as volatility in capital outflows began to increase. The most likely consequence is a slowdown in growth in the short term. The depreciation of exchange rates has increased import prices and resulted in inflationary pressures which are eroding demand in the private sector. This is all the more damaging as a large number of countries (particularly the most vulnerable) are deprived of the possibility of using expansionary monetary policies to stimulate demand (Brazil): as the level of inflation is already high, a fall in interest rates could encourage capital flight.

Beyond macro effects, the microeconomic impact will without doubt be the most destabilizing if new pressures were to resurface. This is because companies – especially the smallest – are highly vulnerable to fluctuations in exchange rates, as a depreciation of the exchange rate makes transactions and refinancing debt denominated in dollars more expensive. In this respect, the risk of non-payment is higher, opening up the possibility of greater increases in corporate insolvencies. The most vulnerable sectors are probably construction, which is hampered by higher input prices, and the IT sector due to its high degree of dependence on imports of technological goods from emerging countries. In this context, emerging countries are forecast to record a slowdown in growth in 2013 (+4.1%) and a modest acceleration in 2014 (+4.6%), underpinned in particular by satisfactory economic dynamics in Asia.

> Geopolitical tensions still constitute a downside risk for the global recovery.

The social and political tensions that resurfaced in Egypt early in the summer and tensions following the threat of military strikes against Syria weighed on the oil price (+9% since the start of July to USD 109.50, an equivalent increase to that recorded between the end of 2012 and February 2013 during the increase in tensions between Iran and Israel). In addition, oil production was halted in Libya, Iraq and Nigeria. Syria, which produces less than 0.5% of the world's oil, is not a major player in the oil market. But it is the risk of the Strait of Hormuz being blocked by Iran (an ally of Syria) which constitutes the main concern. 30% of global oil passes through this strait, ahead of the Strait of Malacca. The "decrease" in the Syria risk eased some pressure on the world's leading oil-producing region, the Middle East, as well as on the oil price. The latter has been bolstered by an increase in production in Saudi Arabia and the United States. The underlying situation nevertheless remains to be stabilized and the risks remain high. Assuming status quo for Syria (ruling out foreign military intervention) and for Iran, we predict an average Brent price of USD 110 per barrel in 2013. In 2014, the oil price should remain around USD 113 per barrel on average insofar as additional oil production capacity to meet renewed growth in global demand for oil remains limited. This suggests the adjustment will take place through prices. ■

Liquidity and cyclical risks in emerging countries



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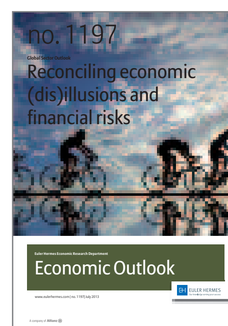

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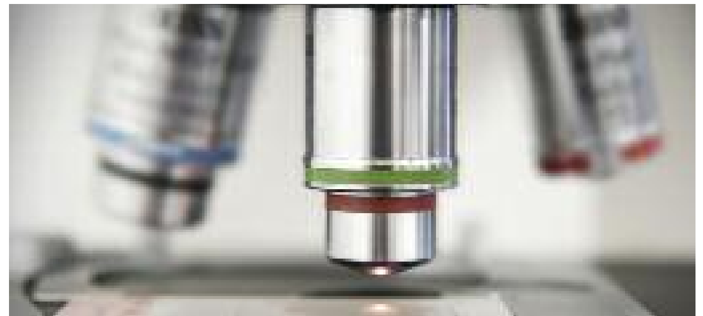

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Registered office :
Euler Hermes Group
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92078 Paris La Défense - France
Tel. : + 33 (0) 1 84 11 50 50

www.eulerhermes.com

▶ Argentina
Solunion
Av. Corrientes 299 - 2° Piso
C1043AAC CABA,
Buenos Aires
Tel: + 54 11 4320 7157/77

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Euler Hermes Australia Pty Ltd
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Level 9, Forecourt Building
2 Market Street
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▶ Austria
Prisma Kreditversicherungs-AG
Himmelpfortgasse 29
1010 Vienne
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Euler Hermes Collections GmbH
Sweigniederlassung Österreich
Handelskai 388
1020 Vienne
Tel: + 43 1 90 81 771

▶ Bahrain
Please contact United Arab Emirates

▶ Belgium
Euler Hermes Europe S.A. (N.V.)
Avenue des Arts — Kunstlaan, 56
1000 Bruxelles
Tel: + 32 2 289 3111

▶ Brazil
Euler Hermes Seguros de Crédito S.A.
Avenida Paulista, 2,421 — 3° andar Jardim Paulista
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▶ Canada
Euler Hermes Services Canada, Inc.
1155, Boulevard René-Lévesque Ouest Bureau 1702
Montréal Québec H3B 3Z7
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Ave. Presidente Kennedy 5735
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▶ China
Euler Hermes Consulting (Shanghai) Co., Ltd.
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▶ Colombia
Euler Hermes Colombia
Calle 72 6-44 Piso 3 - Édificio APA
Bogota
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▶ Czech Republic
Euler Hermes Europe S.A.
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186 00 Prague 8
Tel: + 420 266 109 511

▶ Denmark
Euler Hermes Danmark, filial af
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Amerika Plads 19
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▶ Estonia
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▶ Finland
Euler Hermes Europe S.A.
Suomen sivuliike
Mannerheimintie 105
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▶ France
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92 048 Paris La Défense
Tel: + 33 1 84 11 50 50

▶ Germany
Euler Hermes Deutschland AG
Friedensallee 254
22763 Hambourg
Tel: + 49 40 88 34-0

Federal Export Credit Guarantees
Friedensallee 254
22763 Hambourg
Tel: + 49 40 88 34 90 00

Euler Hermes Collections GmbH
Zeppelinstr. 48
14471 Postdam
Tel: + 49 331 27890-000

▶ Greece
Euler Hermes Emporiki SA
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Euler Hermes Hong Kong Services Ltd
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Euler Hermes India Pvt.Ltd
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▶ Indonesia
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▶ Ireland
Euler Hermes Ireland
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Euler Hermes Acmar
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Tel: + 212 5 22 79 03 30

▶ The Netherlands
Euler Hermes Nederland NV
Pettelaarpark 20
5216 PD's-Hertogenbosch
Tel: + 31 73 688 9999

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Towarzystwo Ubezpieczen
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ul. Domaniewska 50 B
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Tel: + 48 22 363 6363

▶ Portugal
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Euler Hermes Europe SA Bruxelles
Sucursala Bucuresti
Str. Petru Maior Nr.6
Sector 1,
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Euler Hermes Europe SA, poboka poist'ovne z ineho clenskeho statu
2012: Plynárenská 7/A
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Rm 1411, 14/F, Sayong - Platinum Bldg
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Avda. General Perón, 40
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▶ United Kingdom
Euler Hermes UK
1 Canada Square
Londres E14 5DX
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