Sovereign Risk: Shifting Gears to Fiscal Consolidation, Will it Work This Time?

Key Points

- Market discipline has forced heavily-indebted countries to implement credible plans for fiscal austerity in the coming years. If the market loses confidence in these plans, we expect further challenges to the recovery and new challenges to political and social cohesion.

- Despite the European Financial Stability Facility to support challenged peripheral euro zone countries, investors remained concerned about the possible of debt restructuring and the systematic implications of fiscal problems in Europe. We expect sovereign risk will be a key source of volatility for the global banking sector as there continues to be a strong correlation between bank and sovereign CDS spreads.

- The market continues to scrutinize and apply financing pressures to Greece, Ireland, Portugal — all suffered multiple sovereign rating downgrades while remaining on Negative outlook. There is a risk that fiscal austerity measures will keep the economic growth too low, making it more difficult to achieve progress in fiscal consolidation and debt reductions.

- We maintain our policy of rigorously assessing sovereign credit risks before we invest in any sovereign debt on behalf of our clients. Our key credit considerations include: the progress on the implementation of fiscal austerity measures, monetary flexibility, general and external debt burden, and susceptibility to headline risk.

- The risk of a material increase in interest rates has complicated the fiscal adjustments in developed countries. Given the continued economic and fiscal challenges faced by many sovereigns, we expect the relative economic performances of many European countries to diverge further. We continue to opt out of exposure to financial institutions and the sovereigns with the clear potential for headline risk and higher than desirable risk of downgrade. We expect Nationally Recognized Statistical Rating Organizations (NRSROs) to continue with their negative rating actions on certain sovereigns to levels not seen in several decades.

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Euro Zone Bailout - Greece, Ireland and Portugal

In our **previous sovereign advisory** we commented on the expectation of a turbulent 2010 for sovereign debt followed by heightened negative NRSROs rating actions (See Exhibit 4). We stressed the importance of ongoing sovereign due diligence and addressed key criteria for financial issuers.

During 2010, concerns about rising government deficits and debt levels in advanced economies triggered a confidence crisis and widening of bond yield spreads on peripheral European countries with parts of the market voiced a potential breakup of the European Monetary Union. Initially, the crisis centered on Greece, the first country to seek an external bailout, and subsequently, contagion spread to the other peripheral European countries. In May 2010, the €110 billion rescue package for Greece was announced by euro zone member states. Subsequently, a €750 billion stabilization package was agreed by both the European Union (EU) and the

International Monetary Fund (IMF). This package included the creation of:

- The €440 billion European Financial Stability Facility (EFSF) with €250 billion effective lending capacity
- The €60 billion European Financial Stabilization Mechanism (EFSM)
- An additional credit line from the IMF for a maximum of €250 billion

Subsequently, an €85 billion bailout for Ireland and its banks was announced in November 2010.

The announcement of the rescue package sent a strong signal of support to the preservation of the euro and the European Monetary Union and had a decisive impact on market sentiment soon afterwards. However, spreads on bonds issued in the euro zone have widened again, with speculation about uncertainty of debt crisis management or possible debt restructuring.

Following Greece and Ireland's request, Portugal asked for funding assistance from EFSF in early April 2011 and announced an agreement in May on a €78 billion three-year loan package from EU and IMF, as the country's political, budgetary and economic challenges caused its funding costs in the capital markets to soar to an unsustainable level. The conditions of the package appeared similar to that of Greece and Ireland, including a strict conditionality clause, fiscal adjustments, structural reforms and measures to ensure financial stability, such as budget deficit cuts, and reforms to enhance growth and competitiveness and to maintain the liquidity and solvency of the financial sectors.

Given the systemic nature of the sovereign crisis last year, the EU has been cognizant that default of one EU member could potentially weaken the market access of other member countries and the solvency of the European banking systems. Nonetheless, widespread support to date has been achieved, although not without the expected political contention and rhetoric between member countries as politicians from Europe's largest economies were loathe to increase the tax burden on their own citizens in the name of European unity.

The monetary union will have difficulty withstanding financial crisis and Europe's policymakers will always be behind the curve until members agree to a closer political union with an executive capable of setting fiscal policy across region. We feel this is very unlikely, as most European governments are understandably protective and reluctant to lose control over their fiscal policies.

"Euro Plus Pact" Support to Euro Area However, Longer Term Solvency Support Remains Uncertain

In March 2011, EU heads of state agreed on the "Euro Plus Pact" to enhance the Euro area policy framework and reduce the risk of severe macroeconomic and fiscal imbalances arising in the future. The commitment included an increase in the net lending capacity of the EFSF to €440 billion; the establishment of a €500 billion European Stability Mechanism (ESM) by July 2013 to presumably replace EFSF when it expires in June 2013 and the reform of the economic governance of the euro area to restore fiscal balance. The Pact allows EFSF/ESM to purchase the bonds of member governments in their primary debt market, subject to strict conditions.

While these supportive measures are positive to member countries, the availability of longer-term fiscal support from the EU for sovereigns is less certain. Public statements from policymakers suggests that if a country needed support to prevent or restore solvency, ESM would require a comprehensive debt restructuring plan, which in some cases, would entail private sector bail-in or debt write-offs. The role of the liquidity facility is increasingly more important given the sensitivity of sovereigns to interest rate changes. Although these facilities have calmed the markets, the bond yields have not normalized yet as market players are still concerned about the resolution of the ESM which will succeed the EFSF. Yet policymakers have reiterated their intention to take whatever steps necessary to ensure the stability of the Euro zone as a whole.

Doubts about the long-term sustainability of the debt of Greece certainly remains and it's difficult to see a long-term solution that does not involve some form of debt restructuring. Starting July 2013 onwards, euro government bonds may include collective action clauses (provision to grant issuer the ability to impose supermajority bondholders decision to all bondholders) to facilitate such restructuring. In addition, future senior unsecured sovereign debt will be subordinated to ESM loans. These features will be a credit negative to EU sovereign borrower who taps the ESM.

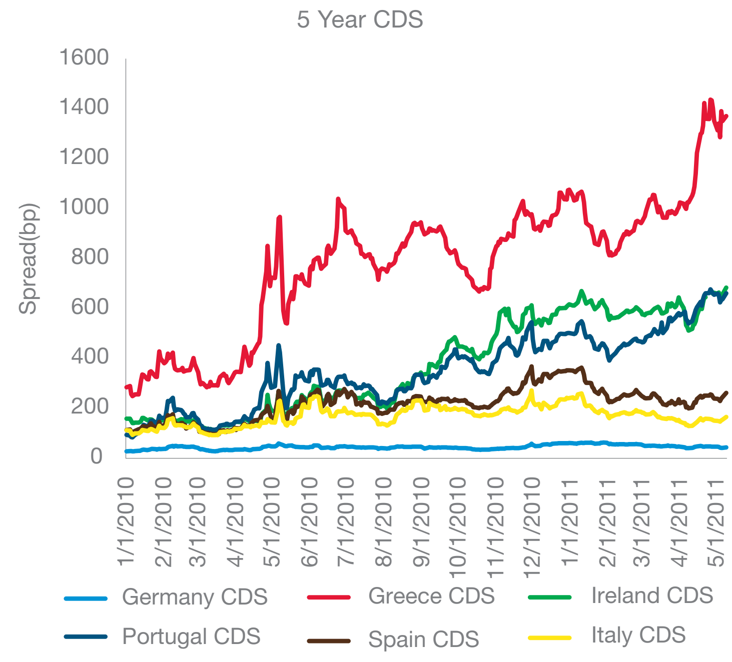
Discussion is still ongoing for the euro zone policymakers on the framework for longer-term support. In the longer term, as their fiscal position and economy recovers, the developed countries will face continued issues with debt sustainability due to rigid monetary policy framework and political risks related to deteriorating demographics.

Diverging Path Among European Peripheral Sovereigns and Financials

In 2010, bond yields and CDS spreads for Portugal, Ireland, Italy and Spain were in a fairly close relative band. The market fear is that if Spain were to need help to refinance its debt or fund its budget deficit, the funding needed over the next two years may leave EU with little choice but to seek a more permanent solution which may involve haircut to the creditors. On the positive side, both bond yields and CDS spreads have improved for Spain and Italy — close to the position of 'core Europe' (Benelux, Germany, France and Italy) — while Greece is still clearly challenged in this regard and Portugal and Ireland are in the middle (see Exhibits 1 and 2).

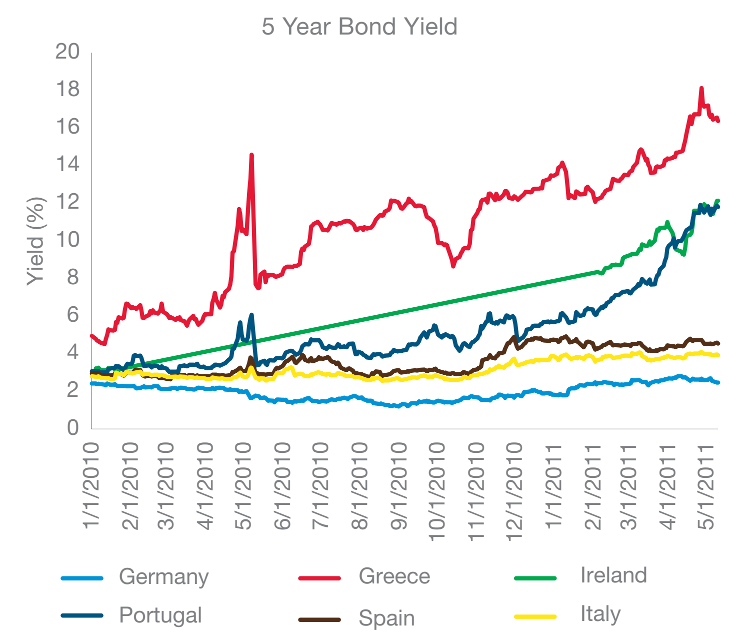
In fact, Spain is among the largest economies in the world with nominal GDP estimated at around $1.4 trillion in 2010. However, it may still be too early to declare victory for Spain, though the country's resilience in both CDS spreads and bond yield is indeed encouraging. We recognize that the Spanish government has taken steps to address the country's key weaknesses, such as moves to consolidate the banking sector, the acceleration of bank recapitalization and embarking on both pension reform and labor market reform — all viewed as credit positives by the market. Nonetheless, Spain remains vulnerable to market disruption compared to peers given the high refinancing needs for sovereigns.

Exhibit 1



Source: Bloomberg

Exhibit 2



Source: Bloomberg

In an effort to reassure markets, EU-wide bank stress tests were conducted in July 2010; however, the market viewed the stress tests as not stringent enough. At the end of 2010, the EU announced its plan to perform another round of bank stress tests, following renewed concerns about the solvency of European banks. The credit markets view the fates of European sovereigns and banks as closely interlinked, with the perception that a bank's creditworthiness incorporates an assumption of sovereign support. We expect continued volatility in European bank and sovereign spreads until the market is convinced that these countries are successful in completing the fiscal consolidation measures needed to generate primary surpluses and reduce their debt burden. In the meantime, the collective willingness of the European governments to support weaker members will remain an important factor to support bondholders.

The Fragile Peace Continues On

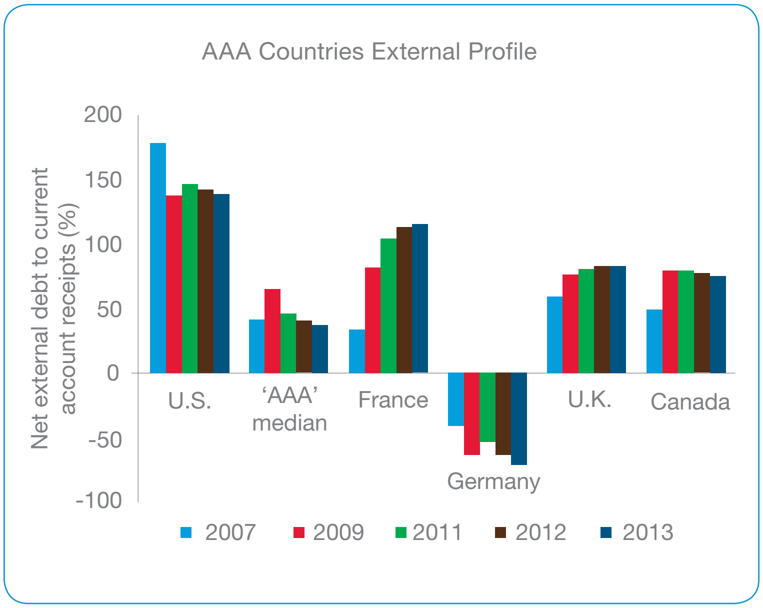
While the EU works towards a permanent mechanism, the European Central Bank (ECB) will have no choice but to walk the fine line of talking tough on inflation while continuing to support peripheral countries via unlimited liquidity and bond purchases in the secondary market. ECB has repeatedly pointed out that the balancing act could involve interest rates being increased even while other extraordinary measures remain in place. The European governments will need to curb the contagion risks in the bond market and the contingent liability that the banking system exposures may have to governments' balance sheets. For core Europe, higher bond yields reflect increased yields globally as well as increased economic activity and resulting inflation expectations. In addition, the market is concerned about potential shared credit risk for all European sovereigns. For peripheral euro area countries, market confidence will remain fragile until the economic adjustment and recovery are secure. Until then, we can expect continued downward pressure on the sovereign ratings and volatility in the bond market.

Highly-Indented AAA Countries: Progress of Fiscal Implementation is Key

For advanced countries with AAA-ratings (see Exhibit 3), while the debt affordability remains high, the credibility of their fiscal strategies will become even more important going forward. The market will want to see the credible actions from governments to control the public debt trajectory without damaging the economic recovery. The reduction in stimulus and simultaneous deleveraging in the public and private sectors may complicate governments' efforts to control the growing debt burden unless structural reforms, including adjustments to pension systems and other labor market reform, are undertaken.

During this very low interest rate environment, debt affordability has not deteriorated as much as it would have been in a higher interest rate environment. However, if the markets were to switch concerns to inflation fears and market rates were to rise significantly, highly-indebted countries could find their ratings tested. Over the next few years, many countries will have to repair their balance sheets in the difficult context of lower growth and without the benefit of declining interest rates, as in the past.

Exhibit 3



Source: Standard & Poor's

Exhibit 4

	Country	Moody's	Outlook	S&P	Outlook
PIIGS	Greece	B1	Watch Negative	B	Watch Negative
PIIGS	Ireland	Baa3	Negative	BBB+	Stable
PIIGS	Portugal	Baa1	Watch Negative	BBB-	Negative
PIIGS	Spain	Aa2	Negative	AA	Negative
PIIGS	Italy	Aa2	Stable	A+	Stable
ADVANCED COUNTRIES	Belgium	Aa1	Stable	AA+	Negative
ADVANCED COUNTRIES	United States	Aaa	Stable	AAA	Negative
ADVANCED COUNTRIES	United Kingdom	Aaa	Stable	AAA	Stable
ADVANCED COUNTRIES	France	Aaa	Stable	AAA	Stable
ADVANCED COUNTRIES	Germany	Aaa	Stable	AAA	Stable
ADVANCED COUNTRIES	Canada	Aaa	Stable	AAA	Stable
ADVANCED COUNTRIES	Sweden	Aaa	Stable	AAA	Stable
ADVANCED COUNTRIES	Denmark	Aaa	Stable	AAA	Stable

Data as of May 10, 2011

Source: Bloomberg

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